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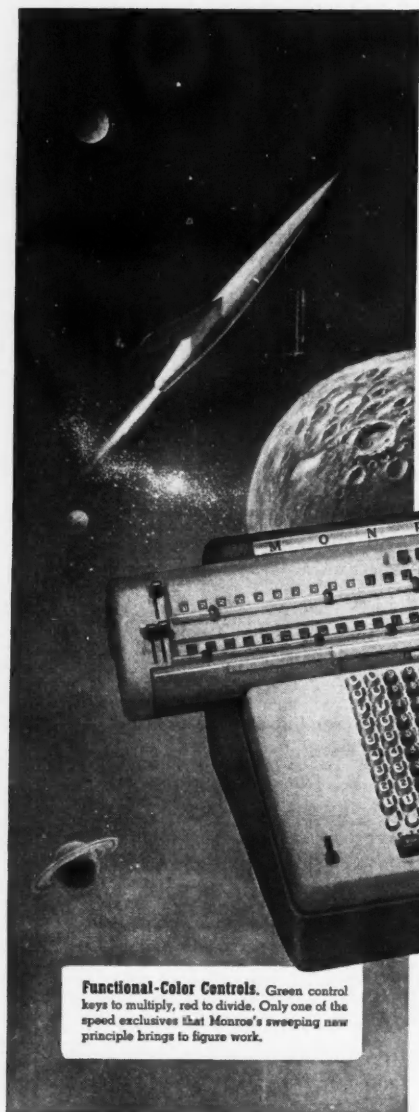
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The Treasurer takes a phone call

"I'd really prefer not to do it myself!" The President was more than usually positive.

"Well, sir —" and the Treasurer never called the President 'Sir' except at times like this "—if you'd rather, I'm certainly willing to do it. If you hadn't been going to Denver for the Convention I would have gone automatically and —"

"Oh, I know that Charley!" the President broke in. "But if you went, you'd collect the amount due, all right, but we'd probably lose the account as a customer—Yes, Miss Trevor?" The President's question was toward his secretary, demurely poised at the half open door.

"I have a call for Mr. Robinson." She looked pointedly at the Treasurer.

"I'll take it here," the Treasurer said, and picked up the phone.

"Oh, yes, Don!" he said.

"Well, well," said the Treasurer, "Denver, eh?" The President looked up at him suspiciously.

"That's fine," said the Treasurer.

"I'll have to let you know," said the Treasurer. "Thanks very much." He hung up.

"Well?" the President inquired.

The Treasurer laughed aloud. "That was Don, our Credit Manager," he went on. "He says American Credit Indemnity has collected the Denver account for us! Don placed the account with them about a week ago, and they have a Service Department to take care of things like that."

"The account not only paid up, but —" and he paused to let his final statement sink in "— they want to duplicate their last order. We'll have to discuss terms with them—or do you want to handle that personally while you're in Denver!"

"I think I'll do just that," said the President gravely. Then he and the Treasurer both laughed, to the great mystification of the President's secretary, once again demurely poised at the half open door.

* * *

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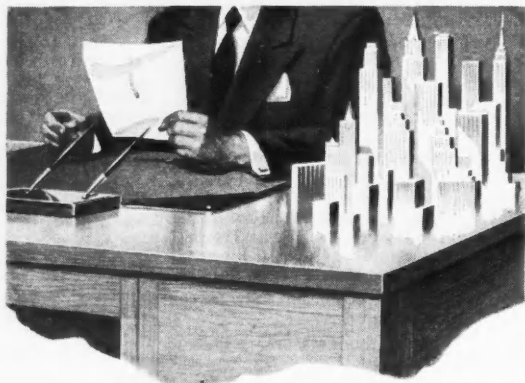
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THE CANADIAN CHARTERED ACCOUNTANT

VOL. 69, NO. 3, SEPTEMBER 1956

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Opinions expressed are not necessarily endorsed by The Canadian Institute of Chartered Accountants

Published Monthly by

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS
69 Bloor Street East, Toronto

Chairman, Editorial Board: C. K. MACGILLIVRAY, F.C.A.

Editor: RENNY ENGLEBERT

Assistant Editor: JEAN VALE

Advertising Representative: E. L. VETTER

*The editor invites members and others to submit articles for publication.
Manuscripts should be typewritten and double-spaced.*

Subscription Rate \$6.00 per Year; Single Copies: Current and five immediately
preceding volumes — 60c; earlier volumes — \$1.00

Printed by General Printers Limited and mailed at Oshawa, Ontario
Authorized as second class mail by the Post Office Department, Ottawa

IN THIS ISSUE

G. O. HUGGAN, C.A.

Profit sharing is no panacea for all employer-employee problems but it has definite advantages and it has produced some amazing results. Too, the growth of pension, profit sharing and savings plans is being accompanied by an expanding role for the professional accountant. Even though the introduction of a company's profit sharing plan may spring from another source, the accountant, with his grasp of financial affairs, is the logical person whose advice and opinion may be sought and to whom management may turn for worthwhile suggestions. In "Profit Sharing Plans in Canadian Industry" George O. Huggan deals with the two general types of plan, cash and deferred, and selects as a case history the plan adopted by his company.

Mr. Huggan is comptroller of Supreme Aluminum Industries Limited. Before joining Supreme Aluminum he was internal auditor and assistant to the comptroller of Gutta Percha and Rubber Limited. He obtained his certificate in chartered accountancy in 1942 and is a member of the Institute of Chartered Accountants of Ontario.

W. R. KAY, C.A.

In "An Accountant Visits a Busy Law Office" W. R. Kay says that costs have increased in law offices as they have in other business and professional firms and recommends that the partners of law firms conduct surveys of their offices and procedures. Mr. Kay not only describes many of the important accounting procedures and

routines but also covers certain aspects of management and control. "A busy lawyer spends so much time in his own office that he might profitably take time off from his clients' problems and view his office through the eyes of an important client calling for the first time", says Mr. Kay. The article should help lawyers to see some of their problems under today's conditions and give them ideas as to what to do about them.

Mr. Kay is a senior partner in the firm of Fred Page Higgins & Co. of Toronto, with whom he has been associated for the past 33 years. Active in community affairs, Mr. Kay is a member of the provincial executive of the Boy Scouts Association and chairman of the scholarship committee of the Kiwanis Music Festival. He is a member of the Institute of Chartered Accountants of Ontario and in 1949 was elected an International Associate of the American Institute of Accountants.

JOHN G. McDONALD, LL.M.

In recent years employers have been compelled by competitive pressures to adopt various forms of fringe benefits in preference to high salaries in order to acquire or retain the services of competent managerial talent. The principal tax provisions dealing with fringe benefits available to the executive group in the community are discussed by John G. McDonald in his article "Executive Compensation". In these days of exceptionally high rates of tax any provision of the Income Tax Act which tends to modify the steep progression of rates is a subject of keen interest.

Mr. McDonald is a member of the legal firm of McCarthy & McCarthy, Toronto. He is the Canadian editor of *Oil and Gas Reporter* and author

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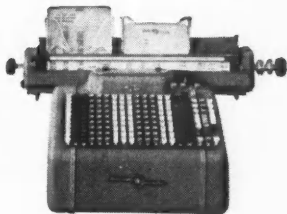
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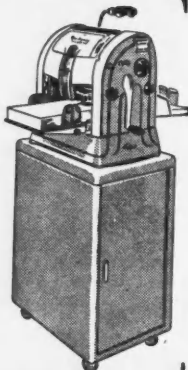
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Special Price 25¢ a copy

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

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of "Canadian Income Tax" (Butterworth & Co. (Can.) Ltd.), and is a member of the British Columbia and Ontario Bars.

JOHN A. PELTIER

Too many people have the impression that electronic equipment is so complex that it can only be understood by highly skilled engineers. Unless these misgivings can be dispelled, the eventual acceptance of electronics will be seriously hampered. So says John A. Peltier who considers that the introduction of electronic equipment is only another aid to management and that a staff will still be required to program its work in every detail.

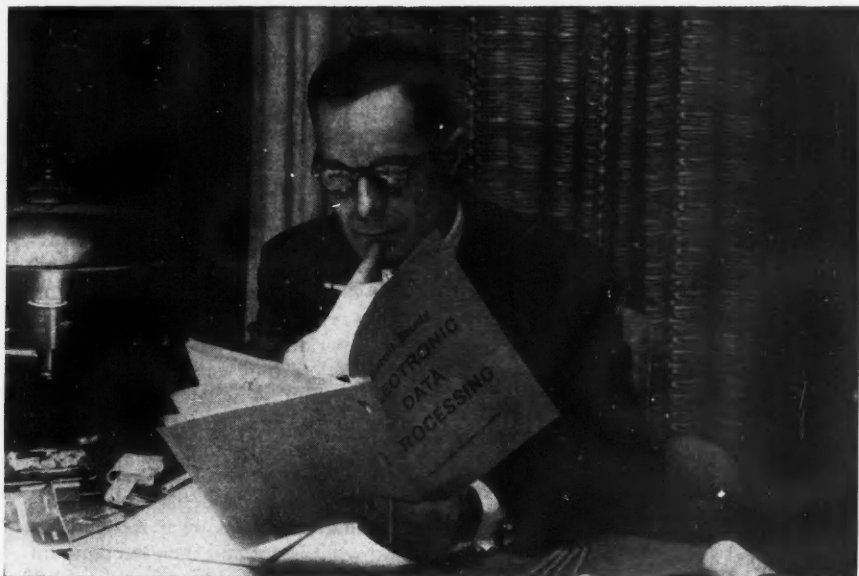
Mr. Peltier was asked to contribute his article "An Evaluation of an E.P.D. Program" as one in the series on electronic data processing. Further articles on this topic will appear over the next six months. From research and practical experience, the author draws his conclusions that a feasibility study can be expected to justify fully the time and cost involved. In fact, many companies have reported that annual savings in administrative costs attributable to an electronic feasibility study have more than paid the cost of the study, quite apart from the decision as to whether to proceed with electronic installation.

Mr. Peltier, formerly with Remington Rand Limited, is a director of the management advisory services group of Price Waterhouse & Company. He has been in charge of electronics and mechanization studies for his company's clients in Canada since 1951.

EDITORIAL

It has been said that modern life today with our press, radio and TV

Continued on page 202



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commentators all trying to tell their stories in a way best calculated to require the least mental effort is not conducive to orderly thought. This seeming inability or unwillingness to think is sometimes borne out by those candidates who fail their examinations. In "Counsel for Candidates", R. G. H. Smails gives some timely advice on the subject and cautions that those who pore over their books for long periods of time are achieving little unless they can tell in speaking and writing — what they did, why they did it, and what the significance of their findings may be. In other words, the art of study, according to Mr. Smails, is being able to discriminate between what is important and what is not and then to communicate those thoughts effectively into words.

Mr. Smails is a veteran in the field of accountancy. He became an Associate of the Institute of Chartered Accountants in England and Wales in 1920 and has been on the Faculty of Queen's University since coming to Canada in 1922. He was elected a Fellow of the Ontario Institute of Chartered Accountants in 1947.

FORTHCOMING FEATURES

BUYING AND SELLING A BUSINESS

John Langdon

THE AUDITOR-GENERAL — WATCHDOG OF PARLIAMENT

Ian Stevenson

ESTATE PLANNING

A. J. Little

TERMINAL GRAIN ELEVATOR ACCOUNTING

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NOTES AND COMMENTS

Tax Times: Less and More

After next January 1 the Minister of National Revenue will have only four years, rather than six, to re-open income tax returns and make reassessments or additional assessments on the taxpayer. Once the four-year period has elapsed, the taxpayer cannot be required to produce and explain income records of prior date.

A further important amendment allows the taxpayer two years, instead of one, to claim a refund for overpayment of income tax.

U.S.-Canada Tax Agreement

A Canadian subsidiary owned 51% by a parent American company will be allowed a Canadian tax rate of 5% on dividends, under terms of an agreement recently reached between Canada and the United States. At present such a subsidiary less than 95% American-owned has to pay a 15% tax. It is expected that this change, which must be ratified by the Canadian Parliament and U.S. Congress, will encourage Canadians to invest in subsidiaries of American companies.

Life Insurance Purchases Increase

The dollar volume of new life insurance bought by Canadians in the first half of 1956 was 16% greater than in the same period of 1955, according to a report by the Canadian Life Insurance Officers Association. Total ordinary life sales gained 18% and group contracts were up 11%, but industrial sales fell by 12%.

An Appeal to Members

An appeal for names of potential subscribers to *The Canadian Chartered Accountant* was included in the recent mailing of the C.I.C.A. annual report. We hope that members will cooperate by sending along as many names as possible so that a sizeable mailing list can be obtained. A circulation drive will follow later this year.

Blueprint for Accounting Education

Future certified public accountants in the United States must be college graduates and will have to take post-graduate professional study in a university school of business administration, if States adopt the recommendations of the Commission on Standards of Education and Experience for Certified Public Accountants whose report was recently published by the Bureau of Business Research of the University of Michigan.

The Commission, which was independent of any accounting body, was headed by Donald P. Perry, C.P.A. of Boston, and included 13 practising C.P.A.'s, 5 deans or former deans of schools of business administration, and past officials of professional accounting organizations.

As a long-range goal that might involve "one or more decades", the Commission proposes that each State consider revising its laws to set up the following qualifications for admission to practice as a certified public accountant:

1. College graduation, with substan-

Continued on page 206

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tial study in the humanities and social sciences as well as in accounting and other business subjects.

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5. Passing the uniform C.P.A. examination.

Admitting that these proposals could not be implemented for some time, the Commission sets as a "transitional goal" that each State consider laws requiring college graduation with an accounting major, or an equivalent program after graduation, before a candidate may sit for the C.P.A. examination. It also recommends that the C.P.A. certificate be granted to each candidate who passes the examination after he has completed two years of practical experience in public accounting under the guidance of a C.P.A.

Copies of the Commission's report may be obtained at \$2.50 each from the University of Michigan Press, Ann Arbor, Mich.

-Getting Ideas Across

"Face-to-face" communication is the topic of a new handbook called "Effective Communication on the Job" published by the American Management Association. Subjects covered in the 296-page book include principles of communication and

good listening, introducing and indoctrinating new employees, giving orders and reprimands, interview techniques, reporting to higher management, conference leadership and public speaking.

Anglo-Swedish Tax Convention

The latest publication of the International Bureau of Fiscal Documentation is a 91-page commentary on the U.K.-Sweden double taxation convention of March 1949. The booklet outlines the tax systems of both countries and shows how the agreement affects their internal legal provisions.

Fined for Illicit Use of "C.A."

On June 28 L. S. Duguay of Montreal was fined a total of \$200 and costs for having signed a profit and loss statement of a local company and adding "C.A." to his signature. The fines were imposed by Chief Judge Edouard Archambault as a result of charges laid by the secretary of the Institute of Chartered Accountants of Quebec.

Tax Foundation New Offices

The Canadian Tax Foundation has moved its office to 154 University Avenue, Toronto 1. The new premises, a short block north of King Street and only four blocks from the Union Station, will provide for the planned expansion of staff and will give suitable space for a library reading room.

In the News

HENRY G. NORMAN, former Canadian Consul-General in New York and a past president of the C.I.C.A., has been appointed the first full-time paid president of the Montreal and Canadian Stock Exchanges, effective October 1.

C.I.C.A.



MEMBERS DIRECTORY

★ a new look

In cooperation with the University of Toronto we are publishing a Directory of Chartered Accountants in Canada which will be available early in November. The directory will compromise approximately 300 pages and will be cloth bound, gold stamped on the face and spine. The price is \$3.00 to members and orders may be placed now. Order forms were mailed with the C.I.C.A. annual report.

★ a new service

In addition to the alphabetical listings by Provinces, two new features have been introduced. Every firm of practising chartered accountants will be listed by towns and Provinces, together with the names of partners or principals. Thus you can see at a glance the firms which are practising in any locality. A third section will be indexed alphabetically for speedy reference. This will obviate the necessity of searching through more than one Provincial listing in order to find a required name.

★ a new coverage . .

This new Chartered Accountants' Directory, apart from being indispensable to members of the profession, will be a useful reference to chartered banks in Canada and abroad, and to other organizations who work with chartered accountants. It is a worthy publication with far greater impact than former editions.

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LETTERS TO THE EDITOR

Toronto, August 10, 1956

Sir: The editorial in the August 1956 issue entitled "About Tomorrow's Auditors" should be required reading for all students in accounting. Those who have passed beyond the student stage (at least so far as the records of the Institute are concerned) will agree with the author that the detailed tasks performed by the student form a necessary and useful ground work on which the rest of his practice will be built.

Most accountants in practice, however, will I think regret one sentence included in the editorial, namely:

"The auditor is appointed by the shareholders and his statutory responsibility is discharged by his services in preventing and detecting fraud and error and certifying to the accuracy of financial statements."

Technically the statutory responsibility of the auditor is to make such an examination of the accounts as may be necessary to express an opinion on the financial statements of the enterprise and, having done so, to express the opinion called for by the statute. In the course of doing so it is true he may detect fraud and error and by his very appointment he may tend to prevent such, but certainly no statement of accounting bodies nor recent text books in auditing would suggest for one moment that he has any statutory responsibility to detect and prevent fraud and error. It would be unfortunate if this sentence were read by itself and taken literally by a reader who was unfamiliar with the duties and responsibilities of an auditor.

J. R. M. WILSON, F.C.A.

Toronto, August 12, 1956

Sir: The editorial in the August issue "About Tomorrow's Auditors" contains excellent advice for the student-in-accounts.

However, there is an objection to the statement that the auditor has a statutory responsibility for the prevention and detection of fraud and error. The responsibility of the auditor appointed by the shareholders, and his primary purpose, is to carry out an examination of sufficient scope to enable him to form an opinion as to whether the financial statements present fairly the financial position of the company and the results of its operations.

In determining the scope of the examination, and in carrying out the audit procedures, the auditor should always consider the possibility of fraud and error being present and, if they are present, they may be exposed by the auditor's examination. Perhaps of more importance is the work of the auditor in the prevention of fraud and error. The audit examination not only serves to discourage attempts at fraud, but the adoption of the auditor's recommendations on good accounting procedures and division of duties assists greatly in the prevention of fraud and improves control over the clerical accuracy of the bookkeeping.

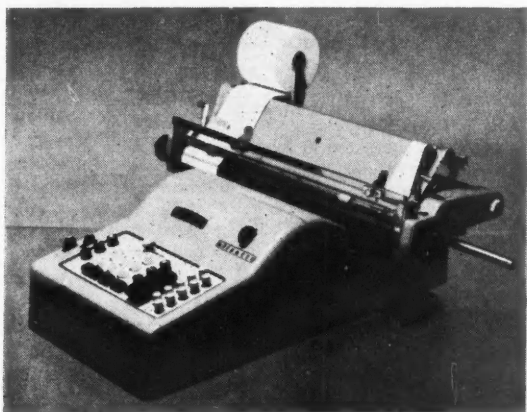
W. A. SIMONTON, C.A.

Toronto, August 13, 1956

Sir: In the editorial "About Tomorrow's Auditors" appearing in your August issue, I was somewhat surprised to find the following:

"The auditor is appointed by the shareholders and his statutory responsibility

Continued on page 210



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is discharged by his services in preventing and detecting fraud and error and certifying to the accuracy of financial statements."

If the foregoing refers to the responsibility of the auditor appointed by the shareholders under either the Companies Act, 1934 (Canada) or, generally speaking, under Companies Acts of the various Provinces, I cannot entirely agree with the views expressed, because of the stress laid on "preventing and detecting fraud and error".

While it is true that a well conducted audit may prevent and detect fraud and error, under the various Companies Acts the auditor's statutory responsibility is, in general terms, confined to reporting to the shareholders on the financial position of a company, as shown by its annual financial statement.

J. G. ARTHUR, C.A.

Toronto, August 15, 1956

Sir: I was very much interested in reading the editorial entitled "About Tomorrow's Auditors" in the August issue of *The Canadian Chartered Accountant*. This editorial presents very well the challenge and the opportunities to be found in our profession. It does, however, contain one statement which, in my opinion, is subject to improper interpretation and might

leave the student or young practitioner with a wrong conception of his duties as an auditor. I refer to the sentence which states: "The auditor is appointed by the shareholders and his statutory responsibility is discharged by his services in preventing and detecting fraud and error and certifying to the accuracy of financial statements."

In the first place, I do not believe that the auditor has a statutory responsibility either to prevent or to detect fraud and error. Other than to advocate systems and procedures that would make fraud difficult, it would be impossible for an auditor to prevent fraudulent actions in his clients' offices. And I know of no statutory requirement that an auditor shall prevent errors in his clients' books. Indeed it would be a superman who could perform that duty in this imperfect world. Again, while the exercise of proper care and judgment is implied in the statutory requirements relative to the auditor's examination of the records, I do not believe he has any legal responsibility to detect fraud and error so long as he has applied accepted auditing standards with care and diligence. Finally, I would suggest that a careful reading of the statutes will show that the auditor's responsibility is to report upon his examination of the financial statements and not to certify to their accuracy. The statutes, of course, lay down certain other duties of the auditor which I need not enumerate here.

W. M. BRACE, F.C.A.

DIRECTORY OF CHARTERED ACCOUNTANTS IN CANADA

Topographical List of Firms and Sole Practitioners

The University of Toronto Press reports that a number of the blue cards supplied for the topographical listing of firms and sole practitioners have not been returned. Those who have not yet mailed their cards are urged to do so AT ONCE as the directory is shortly to go on the press.

If additional cards are needed, they may be obtained either from the Canadian Institute office or the University of Toronto Press, Toronto.

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Editorial

COUNSEL TO CANDIDATES

Just as a good stockkeeper must have an intimate knowledge of his stock and be able to produce promptly on requisition precisely what is required, so a candidate for examination must have accumulated a mass of factual information and be able to assemble smartly the appropriate facts at the appropriate time. However, in any examination which is not purely and wholly technical, the candidate has to do more than this; he must demonstrate his ability to apply selected facts and experience to the formulation of judgments.

In the amassing of factual knowledge by the study of text books, there is no substitute for hard work. But there is art (or is it guile?) even in this process, for no one, unless endowed with a prodigious memory, could memorize in the time available all the facts in all the texts he has to study. The art is in discriminating between what is important and what is not, and in concentrating time and energy on the first of these. Study outlines may be available to help the student in this respect, but always in the last analysis it is he himself who must exercise the judgment.

Probably most students pore over their books for long periods, but it does not follow that they are studying effectively. To be running one's eyes over the type without a positive and effective effort of concentration is to waste one's time. The most important aid to the will in achieving the necessary concentration is to impose upon one's self a hard and fast schedule of study periods and to apportion each period between straight reading and creative effort. By creative effort here is meant the working of problems not necessarily related directly to the current studies and the writing out in one's own words of answers to narrative questions or of a precis of what has been studied in the text book.

If drowsiness threatens the study period (as it may often do when that period is in the evening following a hard day at the office) it must be doggedly fought off with whatever weapon, other than drugs, that the student can muster. A short interval of physical exercises is sometimes a help.

Assuming that the candidate enters the examination room with a well-stored mind, he has the task not only of deciding what facts con-

stitute an answer to any question put to him (and he should be sure he knows precisely what the question is) but also of communicating his knowledge to the examiner.

It is not enough to know; one must also be able to tell and "telling" is a finer art than just "knowing" and one for whose mastery there are no simple rules. Failure to communicate successfully is a matter of emotion and not merely of vocabulary. One thing a candidate should do, therefore, is to accept our assurance that he has no ground for fear or suspicion of the examiner, that the examiner will be scrupulously fair to him and will give him the benefit of any reasonable doubt as to the meaning of his words. So far as communication is a matter of vocabulary and syntax, much can be learned painlessly over the years by reading such master story tellers as Kipling, Somerset Maugham and Hemingway.

More painful but of more immediate help is the device of writing out, in full, answers to narrative questions and then a day or two later reading these answers over again, bringing to bear on them all the critical faculty one possesses. (Here the married student has one advantage.)

The third and highest quality tested by an examination is the ability to form a sound judgment in a specified set of circumstances. No formal subjects can be recommended for the development of this faculty. A grasp of logic is essential, broad experience is helpful and an obstinate tendency to argue with one's seniors will not do any harm — at least to the seniors.

AN INDISPENSABLE AID

The Committee on Education and Examinations has sponsored what we consider to be a "best seller". "Chartered Accountant Examinations in Canada — A Guide for Students" is a must in the library of every student who aspires to become a member of the profession. It represents the ideas and opinions of six of our members recognized as leaders in the educational and examination aspects of our student training. It is packed full of excellent suggestions which should be followed by all students as beacons leading to the successful completion of years of study. Every student should read, reread and completely digest all the articles in this examination brochure. It is an opportunity for guidance which no student can afford to ignore.

Although designed for students, this examination brochure can also serve a very useful purpose as a guide to principals. It presents touchstones of success by which members can assess the development of students under their direction. It brings out weaknesses which must be overcome by future members of the profession. "Chartered Accountant Examinations in Canada — A Guide for Students" should be recognized as an excellent contribution in furthering the cause of effective staff training.

An Evaluation of an Electronic Data Processing Program

JOHN A. PELTIER

QUITE A FEW presidents and controllers have an uneasy feeling these days that they should be doing more than they are about evaluating electronic data processing possibilities in their organizations. This article attempts to provide some suggestions for those who are wondering just what approaches might be considered.

Preliminary Considerations

Public interest in electronic data processing machines far surpasses that accorded the introduction of any other type of office equipment. More important, the number of orders for such equipment reported so far by manufacturers is impressive evidence of its acceptance by management as a new business tool. This public interest and management acceptance has been generated as much by the responsible reputations of the manufacturers as by the claims of remarkable speed, versatility, accuracy, flexibility, ability to carry out an uninterrupted sequence of operations by means of a stored program, and facility to process work not previously considered susceptible to mechanization. Perhaps most important of all, management has been greatly influenced by the prospect of sub-

stantial reductions in administrative costs through its use.

The machine manufacturers, on their part, have developed equipment specifically designed for business problems and have also recognized that many business organizations could not justify, or even consider, the very powerful and costly large-scale computers, which may rent for as much as \$40,000 a month, or cost several million dollars to buy. As a consequence, medium and small-scale equipment is being made available in increasing quantity and variety, and it can be anticipated that the field of potential users of these classes of equipment will eventually be broadened to include all sizes and types of business enterprises.

The medium-scale computers, though less powerful, are comparable in many respects to their larger-scale counterparts. They cost from \$4,500 to \$12,000 a month to rent and between \$145,000 and \$500,000 to buy. The small-scale computers, which have few of the characteristics of the other two groups and are relatively restricted in the variety of tasks which they can perform, cost from \$850 to \$1,500 a month to rent and between \$20,000 and \$35,000 to buy.

Classification by Size of Company

Companies can also be classed as small, medium and large, and this grouping, in most instances, indicates reasonably well the opportunities which may exist in each class of company for the use of electronic equipment.

The small company, whose administrative costs do not exceed, say, \$100,000 annually, would not likely be a prospective user of electronic equipment at this time. The economies and other benefits which such equipment would provide could not be offset by a corresponding reduction in administrative and other costs.

The medium company, with administrative costs ranging up to \$1,000,000 or so per annum, could certainly consider small-scale computers and possibly the medium-size equipment as well. But it is unlikely that use of the large-scale equipment would be economical for a company of this size. In this class of company it may be sufficient to appoint one or two individuals to become reasonably knowledgeable about electronic equipment developments, taking advantage of the services which are available from machine manufacturers to assist them in evaluating their problems. Bibliographies of recommended books and articles are available from organizations such as the Controllershship Foundation Inc. and the American Management Association, and many worthwhile ideas can be gleaned from these sources. Management advisory service groups in professional accounting firms are usually thoroughly conversant with electronic data processing; liaison with members of such groups on the staff of the company's auditors can prove to be very helpful in keeping in touch with the latest developments.

The large company, with administrative costs of \$1,000,000 and upwards, can be considered as a potential user of any of the available classes of electronic equipment. Its program of investigation will, accordingly, be on a different scale from that in the medium company.

Need for Investigation

With the variety of electronic equipment now available or being developed, and because of the promise of rich rewards for users, medium and large companies not presently considering or utilizing this equipment will desire before long to evaluate their own possibilities of using it to advantage.

A study of the potential application of electronics is most successful when it is related to known problems and conditions existing in the individual company. Identical circumstances are rarely, if ever, found in either similar or diverse organizations. Each company should therefore determine its own course of action and reach its own conclusions based on its own study. Such conditions as the volume of work to be performed, the location where this work should be processed in relation to its point of origin or use, the speed with which information is required, the number of exceptions to established routines, the need for rapid access to information stored in electronic form, the anticipated savings that may be realized, and the way in which the company is organized can vary substantially even in similar types of organizations. Thus, no set program can be laid out that will be universally applicable. The best that can be done is to outline a general plan that can be readily modified to suit individual needs.

A study to decide the merits or otherwise of installing conventional types of office equipment, whether key-driven or punch-card, can usually be decided without the necessity for a lengthy or costly investigation and often without crossing departmental lines. Not so in the case of electronic equipment! Because of its extraordinary features and cost, an electronic installation can be expected to have an all-pervasive impact on the whole organization. The study must be planned accordingly, with much care and thought, with a clear definition of objectives and the manner in which they are to be approached, and with positive and prompt knowledge of the company's plans disseminated to all levels of management, supervision, and to the work force throughout the organization.

The Coordinating Committee

A coordinating committee, under the chairmanship of a senior executive, should be established to provide top-level support and to ensure the total coverage that an electronics feasibility study requires. The more important responsibilities of such a committee, which must be both representative and authoritative, will be to:

1. Establish both the short and long-term objectives of the study. These objectives should define the scope of the study in each of its phases and set target dates for the accomplishment of each objective.
2. Select the general areas for study; more precise delineation of work areas can await the recommendations of the study group when appointed.
3. Enlist and maintain the cooperation of those departments to be included in the study or that will be affected by it.

4. Select the leader of the working task force and, with him, determine the number and qualifications of the other members of the study team and arrange for their selection and assignment.
5. Decide whether consultants are to be retained. If so, the role they are to play must be defined, their terms of reference carefully established and their selection made.
6. Direct the progress of the study team and consider its recommendations.

As each phase of the investigation is completed a progress report, with interim conclusions and recommendations where possible, should be submitted by the study team to the coordinating committee. In the light of such progress reports and recommendations it will be the responsibility of the committee to chart the future course of action of the study team, make the critical decision whether electronic equipment should, or should not, be installed, and supervise the preparation of the recommendations to top management and the board of directors.

The Study Team

The size and the skills that the study team must possess collectively will depend to a large extent on the size of the company, the number and complexity of the areas to be studied, the length of time which has been allowed for the group to reach its conclusions, and upon the decision as to whether or not outside consulting advice and help will be made available.

Once the course of action has been determined, it is important that the group be provided with the proper facilities and sufficient time to enable it to reach sound conclusions, since

the results of its work are likely to have a pronounced effect on the company's future. Incorrect decisions based on incorrect conclusions could result in the company being committed to major procedural changes at heavy expense without the hoped-for results or anticipated economies being achieved. Contrariwise, they could lead to the equally serious decision not to proceed with an electronic installation, thereby possibly forfeiting to competition the advantages which this equipment might provide.

In selecting the study group, it is desirable to look for members with these abilities and knowledge:

1. A thorough knowledge of the policies and objectives of the company and an understanding of the concepts which guide management. Without this knowledge and understanding, the group cannot develop procedures capable of producing the kind of information which will be of maximum value to those who must use it.
2. Skill in systems analysis. The analysis of existing procedures and the determination of what they should be is one of the most important time-consuming tasks of an electronics study.
3. A thorough knowledge of the operation and application of book-keeping and tabulating machines. This knowledge is essential if the group is to evaluate other methods which could be used to perform the work being studied. Without it, it will not be possible to determine where the advantage lies, or does not lie, in favour of electronic equipment.
4. Familiarity with the essentials of programming, i.e., the preparation of a set of instructions in machine code which represents each step that the machine must follow. General familiarity with techniques will be needed to evaluate properly the various types of electronic equipment. A thorough knowledge of computer programming will not be required until a decision is reached to proceed with an electronic installation.
5. Knowledge of legal and audit requirements and the fundamentals and application of internal control. The extent to which records are susceptible to audit procedures and sound internal control must be given thorough consideration if the proposed plan is to gain eventual acceptance.
6. Analytical ability, imagination, quick absorption of new concepts and techniques, sound judgment, and the ability to evaluate clerical and other costs are additional desirable qualifications of members of the group. As it will be their responsibility to submit and explain recommendations and new ideas to others, they should have the complete confidence of management and endeavour to increase this confidence by their presentation and support of well-reasoned conclusions.

Once the group has been formed, every effort should be made to increase its technical knowledge of electronic equipment. Opportunities to attain this knowledge are available through manufacturers of equipment, and conferences and conventions presented by business groups and associations. Many articles and books have been written on the subject and selected lists of recommended reading are easily procurable. Visits to com-

panies which have electronic equipment installed and in operation will prove a fruitful source of information, and the experience of users will greatly assist the group to formulate and finalize its own course of action. The manufacturers of equipment are ready and able to assist the company in assessing the possibilities of their products.

Areas For Study

When the study group has been formed and its objectives clearly defined, it should first direct its efforts to determine the areas of work to be studied. It would be logical to explore first those areas in which reduction in administrative costs could be expected as a result of conversion to electronic equipment. If it can be demonstrated that the equipment could quickly and continuously pay its way, a solid foundation for the installation will have been established and the decision to proceed will be more readily forthcoming.

The areas in which economies are to be expected usually consist of massive routine procedures with a high proportion of repetitive operations. Certainly, the most promising would be those where a great volume of paper-work is being processed by a large group of clerical employees in a centralized location. Other areas which should prove fruitful include:

1. Work requiring extensive computation.
2. Procedures, now mechanized, which might be susceptible to improvement if converted to electronic equipment.
3. Decentralized operations which could be processed centrally because of the existence of good communication facilities.

4. Procedures which, because of their overall complexity and size, have been broken up into several parts and distributed between various units within the organization, thereby resulting in a substantial element of duplication.

Once these and other areas of a similar nature have been explored, attention can be directed to those functions where tangible savings cannot be clearly evaluated. As an example, more concise and informative management reports are a desirable objective. Too frequently more information of a routine nature than can be properly digested comes under management review. As electronic equipment has the facility to segregate information requiring attention, it provides the opportunity to apply the principle of management by exception. By reviewing such selected information, management is placed in the position of being able to make decisions promptly which may well result in substantial operating economies.

Because the areas most susceptible to conversion to electronic equipment will vary among different companies, some may desire to consider only such applications as payrolls, cost analysis and control, budget analysis, sales statistical analysis and materials control. Others may desire to integrate such functions as inventory control, production planning and control, parts procurement, and factory scheduling adjusted to reflect demands for products based on the realization, or otherwise, of sales forecasts and market research. Specialized industries will, of course, have specialized problems, for example file maintenance, premium billing and valuation work in insurance com-

panies, customer billing in public utilities, or freight and revenue accounting in railroads.

Once the areas of study have been selected, the study group should then apply itself to an analysis of each area in logical sequence.

The Survey

In conducting the study, the group should first direct its efforts to informing those who will be affected by it of the objectives to be achieved. As their cooperation and understanding will be essential to the ultimate success of the study, they should be acquainted with the basic principles of electronics. Every effort should be made to correct any misconceptions about what electronics is and what it can do. Too many people have the impression that electronic equipment represents "push-button" accounting or the automatic office and that it is so complex that it can only be understood by highly skilled engineers or mathematicians. Because of these misconceptions and a lack of understanding of the equipment it is not surprising, therefore, that the possibility of its introduction into the company often causes misgivings to the uninformed. Unless these misgivings can be dispelled, the eventual acceptance of electronics will be seriously hampered. It must be clearly understood by those who might be affected by the introduction of electronic equipment that it is only another aid to management and a staff will still be required to program its work in every detail and interpret the information which it produces.

The study group will be required to analyze present procedures in sufficient detail to determine whether an electronic installation is feasible. At this stage of the study approxima-

tions are sufficient and a detailed analysis of each minor operation and exception is inadvisable. It will be time enough to develop procedures in detail when the decision to install the equipment has been reached. It may be found, during the preliminary study, that the application being studied is unattractive for electronics or that improvements in existing procedures can be made which would substantially alter the need for electronics. It is only in the light of the best possible manual or mechanical procedures that the advantages to be derived from electronics should be judged.

If it appears feasible and desirable to give further consideration to electronics, a more detailed study of the procedures will then be necessary. During this second stage of the investigation careful consideration will need to be given to the nature and extent of the storage requirements, the equipment speeds which will be necessary to produce the required results in the time available, the programming steps that must be followed, access requirements to information stored in electronic form, and the ability to schedule the applications to avoid conflict between them. Once these and other similar problems have been solved, consideration can be given to the most suitable size and type of equipment needed to produce the desired results.

In assessing the equipment presently available, consideration has to be given to both its operating characteristics and its estimated cost as opposed to the savings and other advantages which might be expected to accrue to the company from its use. Moreover, as the cost of investigation, development, and conversion to elec-

tronic equipment may be substantial, the period of time that must elapse before those expenses can be reimbursed by the savings anticipated should be carefully forecast. When this stage of the investigation has been reached, the study group should be prepared to summarize its conclusions and submit final recommendations to management. The report should contain a detailed comparison of the cost of present and proposed methods, the equipment selected and its capabilities, sample programs and estimated processing times.

If, after considering these conclusions and recommendations, the decision is to proceed with an installation of electronic equipment, a detailed charting of the procedures, with all exceptions clearly defined, will be required to enable the preparation of machine programs. As this phase of an electronic study is the most time-consuming of all, the thoroughness with which the feasibility study has been conducted will contribute substantially to reducing this phase of the work to a minimum.

The Benefits

The benefits to be gained from a feasibility study can be expected to justify fully the time and cost involved.

A clear understanding of the company's position with respect to existing electronic equipment will have been established. If the results are in favour of the installation of electronic equipment, a sound basis of evaluat-

ing the equipment best suited to the company's needs will have been achieved. A group of people, qualified to extend its work to the programming and installation of the selected equipment, will have been assembled. If it is decided not to proceed immediately with the installation, the possibilities and limitations will have been defined. The company will be in possession of the information necessary to judge the future developments of the equipment and to assess these developments in relation to its own problems.

Because of the critical examination to which existing procedures will have been subjected, a clearly defined course of action for methods improvement, with or without electronics, will undoubtedly have been found. In fact, many companies have reported that annual savings in administrative costs attributable directly to an electronic feasibility study have more than paid for the cost of the study, quite apart from the decision as to whether to proceed with electronic installation.

A better understanding of the common objectives and interrelated problems of the company as a whole will be shared by those who participated in the study, thereby fostering an atmosphere of closer cooperation within the organization. In addition, the company will be secure in the knowledge that it has made every effort to take advantage of the latest and best techniques available to modern management.

An Accountant Visits a Busy Law Office

W. R. KAY

COSTS HAVE increased in law offices as they have in every other profession or business. Fees may have increased too, but many busy lawyers wonder whether their gross and net incomes have kept pace with higher costs of rent, taxes and other office overheads, particularly staff salaries. Some complain that today the net return to the partners is considerably less than it was 10 or 15 years ago. The existence of this condition should prompt the partners of a busy law firm to conduct a survey of their office and its procedures. Such a survey is almost certain to reveal points for improvement.

Reception

Whenever a visitor appears in person at a law office or calls on the telephone, he will receive a favourable or unfavourable impression of his reception. Obviously clients and others should be treated courteously and made to feel "at home", and a pleasing receptionist is an asset to any firm. Likewise a cool-headed telephone operator (who may be the same person) will bring compliments from time to time on the efficiency of the office. An inefficient person will be a constant source of exasperation and may do the firm irreparable damage.

The receptionist and telephone operator, however, have a second responsibility to the office of which clients have very little knowledge. They should be required to maintain an accurate daily record of every visitor and every telephone call, both long distance and local, the time and duration of the call, the name of the caller and the name of the lawyer. They can have additional duties such as the making of hotel and travel reservations, maintaining the petty cash funds, keeping a record of the whereabouts of students, etc., but the accurate record of the time and duration of visits and telephone calls should not be delegated to others.

The first step in the survey of a law office is to ascertain whether the receptionist and switchboard operator have been assigned the duties referred to and whether they are carrying them out.

Office Furnishings

The busy lawyer spends so much time in his own office each day that he may have become accustomed to shabby furnishings, dirty walls, untidy accumulation of files and correspondence. He might profitably take time off from his clients' problems to visit his own office and view it

through the eyes of an important client calling for the first time.

Modern offices, to be efficient, need not be elaborate but should be clean and tidy. Particular attention should be given to the lighting throughout the entire office. Poor lighting will impair the efficiency not only of the lawyer but of all other members of the staff. A new arrangement of lighting and an investment in lighting fixtures might be well worth while. Air-conditioning is becoming generally accepted.

If the office has become crowded, a new layout of the space and its furnishings might be much more profitable than moving to larger quarters at an increased rental.

Fire Hazard

What would happen to the busy law office in the event of a fire after office hours? A fire completely destroyed a prominent law office in St. Catharines, Ontario, a few years ago, but fortunately an office rule called for the placing of all files, documents, correspondence and accounting records in the vault at closing time. In a more recent fire a prominent barrister, apparently the owner of his own office building, found himself in the ignominious position of having to ask the firemen to save the valuable legal documents in his second floor office.

Office Equipment

Office equipment should periodically be appraised from the standpoint of efficiency and from time to time traded in on new appliances, just as is the practice with automobiles.

Modern equipment is attractive and expensive, but it is efficient and, incidentally, subject to rather generous depreciation for income tax purposes.

In making his choice, the lawyer should listen to the recommendations of his own staff.

Electric typewriters are as inevitable as power steering. Other items assisting the typist are posture chairs, copy holders and dictating equipment, including wire and tape recorders. Every office should acquire a machine for making photo copies. Mailing equipment which will reduce the cost of postage is now available for both large and small offices. A new machine shreds papers in such a manner that the waste paper cannot be deciphered.

Office Manager

To function properly the busy law office will make one person on its staff, preferably not a lawyer, the office manager. Though he may have other duties, his responsibilities are primarily keeping the accounting records up to date, purchasing supplies, hiring personnel and particularly supervising the work load of the various members of the stenographic staff. The office manager, in turn, should respond to one partner of the firm.

Statistics

It would be interesting to compare the gross fees of a busy law office with the widely publicized "Annual Sales of Service" of the George S. May Company which apparently have grown from \$3,886,890 in 1951 to \$9,063,719 in 1955.

It would be more practicable to compare the gross fees of the law office itself with those of, say, 1940 and 1945 and particularly with the increase in the cost of office salaries and other overhead expenses.

A simple comparison might be made:

	Gross Fees	Office Overhead			Partners' Net Revenue	
		Salaries		Expenses		Total
		Legal	Other			
1940	\$	\$	\$	\$	\$	
1945						
1950						
1951						
1952						
1953						
1954						
1955						
Increases						
1955 over 1940	%	%	%	%	%	
1955 over 1945	%	%	%	%	%	
1955 over 1950	%	%	%	%	%	

Expenses

All expenses of a law office are chargeable directly or indirectly to the clients. It is a mistake to include expenses as overhead which can be collected as disbursements. Accounting records should contain separate accounts for each classification of expense, and no two items of expense should be grouped together.

Expenses should be reviewed and carefully analyzed to determine whether any costs which have in the past been included in overhead, such as postage, telegrams, long distance calls, special stationery, travelling, petty cash items, etc., can properly be treated as disbursements.

After deleting items which can be billed to clients, a budget might be prepared as shown at the top of the next page.

To arrive at a conservative monthly budget, the total should be divided by 10 rather than 12.

The monthly budget should then in turn be apportioned against the various lawyers (see "rates per hour").

Chargeable Hours

Partners in the same office generally show a wide variance in the number of hours chargeable to clients' affairs.

Cost records are essential as a guide to billing, but cannot be kept properly unless accurate information is available to show the approximate annual total of chargeable hours for each lawyer.

One authority has stated with emphasis that there are approximately 1850 working hours per annum, al-

BUDGET OF OFFICE OVERHEAD

	1955 Actual	1956 Budget	Charge to Clients	1956 Revised Budget
Salaries				
Legal				
Other				
Expenses				
Rent				
Postage				
Travelling				
Stationery				
etc.				
etc.				
	\$	\$	\$	\$

though it is doubtful if this average has been maintained.

In the accounting profession averages of 1500 and 1600 chargeable hours per annum are commonly used for costing purposes. Whatever figure is taken it should be conservative. In the busy law office it might be more accurate to adopt standards of chargeable hours for costing which would change from time to time in reverse relationship to the age and experience of the lawyer. Junior lawyers might charge, say, 2000 hours

per annum to clients whereas senior partners, particularly if they devote a large part of their time to public affairs, might charge only 1000 hours to clients.

Rates Per Hour

Given the average annual drawings of each lawyer, the office overhead and the standard number of chargeable hours, the minimum hourly rates for costing purposes can be readily determined for each lawyer as follows:

Lawyer	Annual Drawings	Office Overhead	Total	Chargeable Hours	Cost per Hour
A	\$ 30,000	15,000	45,000	1,800	\$ 25.00
B	20,000	10,000	30,000	1,500	20.00
C	30,000	15,000	45,000	1,500	30.00
D	20,000	10,000	30,000	2,000	15.00
E	33,333	16,667	50,000	1,000	50.00
F	6,666	3,333	10,000	2,000	5.00
	\$140,000	70,000	210,000	9,800	

Divide each lawyer's total by 10 rather than 12 to obtain a conservative budget of fees to be billed each month.

No doubt every law office has already determined its minimum hourly rates for costing purposes in this manner. It is suggested that they be recalculated each year.

Costing rates are not billing rates. Billings should equal or exceed the costs; otherwise the office will not meet its expenses. The cost of stenographic services should be added to the cost of legal services.

The Lawyer's Diary or Daily Time Sheet

Every practising lawyer keeps a daily diary. This can be the most important record in the office.

Duplication of records can be minimized if the diary is generous in size with ample space for recording:

- (a) name of client,
- (b) name of case of "re",
- (c) wide column for brief description of work performed, using abbreviations.
- (d) time engaged in hours and one-tenth hours or minutes.

The best person to make the entries in the daily diary is the lawyer himself. If properly kept, it is the only original record in the office with which the lawyer need directly concern himself. Some lawyers prefer to dictate their time charges each day using the diary entries, copies of correspondence and letter list together with receptionist's record for reference.

The time in the diary should be totalled daily and should show separately time charged to clients and time chargeable to the firm's affairs.

Then the chargeable time can be costed by a secretary or the bookkeeper using up-to-date rates.

Stenographer's Diary or Daily Time Sheet

Because of the rapid increase in the cost of stenographic services, each secretary should keep a diary quite similar to the lawyer's diary, and chargeable time of secretaries should be included as part of the cost of each case.

Some secretaries may be opposed to keeping time sheets; hence the suggestion that a diary be provided.

All stenographic time should be valued at a rate which would cover the full cost of these services, keeping in mind that a very substantial part of each secretary's time cannot be charged to specific clients or cases.

If a rate of \$3 per hour is used for, say, three months, it can then be quickly determined whether the total of all chargeable hours at this rate is approximately the same as the total payroll of the stenographic staff. If after this trial period it is found that \$3 per hour is not sufficient to cover the payroll, the rate should be increased.

To determine whether a cost rate of \$3 per hour is adequate, a summary along the lines shown on page 227 might be prepared.

Office or lost time not chargeable to clients' affairs should then be carefully recorded under several headings:

- (a) Holidays
- (b) Illness
- (c) Firm's records
- (d) Shopping
- (e) Lost time
etc.

THREE MONTHS' SUMMARY

Secretary	Hours			Cost of Clients' Time @ \$3 per hr.	Salary	Difference
	Clients	Office or Lost Time	Total			
A				\$	\$	\$
B						
C						
D						
				\$	\$	\$

Accounting Records

It is presumed that the busy law office will have adequate books of account, that the books are audited and that all employees handling cash are bonded. Excellent standardized loose-leaf ledgers, cash books and other records have been designed especially for law offices and can be purchased at leading stationers.

The only books of account needed are:

- (a) General ledger
- (b) Cash books
 - Cash receipts — general
 - Cash receipts — trust account
 - Cash disbursements — general
 - Cash disbursements — trust account
- (c) Fees books
- (d) Clients' accounts receivable ledgers
 - General
 - Trust.

A journal may be kept, but very few entries should be required. A petty cash book is superfluous. If other books of account are being kept, enquiry should be made as to whether their continued use is necessary.

Every office will, in addition, maintain costing records and memorandum records of various kinds, particularly with respect to renewal and collection dates, appointments, securities lodged for safe keeping, insurance, etc.

GENERAL LEDGER

The general ledger should be posted and balanced monthly.

CASH BOOKS

It is economical and convenient if cash receipts and cash disbursements are recorded in either two separate books or four separate books.

FEES BOOKS

Each lawyer should maintain his own fees book, which should be totalled monthly and initialled by the lawyer to confirm his billings for the month. The totals should then be compared with the lawyer's monthly budget of fees.

If this procedure is carried out for a few months, the trend of the firm's earnings and of the contribution being made by each member will very soon be established.

Every balance in the trust section of the client's ledger must be a credit balance, and the total of these credits must at all times agree with the balance in the firm's trust bank account. This should be verified at the end of each month.

While it is realized that there may be a technical objection to the plan, there is some merit in depositing all receipts in the trust bank account.

Monthly Transfers

Funds deposited or accumulated in the trust bank account to the credit of the clients which will not be required for disbursement or which will not be refunded to the client should be transferred to the client's credit in the general account against partial or full payment of fees and disbursements. These transfers can be made monthly or at more frequent intervals.

Extreme care must be taken to ensure that no such transfer will have the effect of creating a debit balance in any client's account in the trust ledger.

Petty Cash

A reasonable round-sum amount should be advanced to the bookkeeper for petty cash and the petty cash fund operated on the "imprest" plan (a term peculiar to accountants). From time to time the bookkeeper should prepare a list or tape of disbursements made out of petty cash and then requisition a cheque for the exact amount of the total of these disbursements. When cashed, the proceeds of the cheque will bring the fund back to its original amount. This is the only satisfactory method of handling petty cash.

It is suggested that the tape and vouchers be placed in a large en-

velope and that the distribution of the fund be recorded on the outside of the envelope to show clearly and separately office overhead items and disbursements chargeable to clients.

The distribution of the cheque can then be recorded in the cash disbursements book.

Cash v. Accrual Method of Reporting Income

Section 85F of the Income Tax Act permits a taxpayer to compute his income from a profession in accordance with the cash method rather than the accrual method should he so select. There are some arguments in favour of adopting the cash method of determining income for income tax purposes.

If the cash method has been adopted, the bookkeeping procedure can be exactly the same as in the accrual method except that it becomes necessary to adjust the general ledger at the end of each month in a reserve account the amount of which should always be equal to the exact amount of fees billed but not collected.

The firm's monthly balance sheet should then include as an asset "accounts receivable from clients' fees and disbursements" less "reserve for uncollected fees" leaving as an asset "disbursements receivable".

Permission to change from the accrual method to the cash method (or vice versa) of reporting income for tax purposes will be given by the Minister of National Revenue if he is satisfied that the change is not being made to minimize taxation.

Fiscal Year End

Careful consideration should be given to the date of the firm's fiscal year end. There are some real ad-

vantages in adopting a date other than December 31.

If the year ends on August 31, for example, it will mean that each year will start with the beginning of the busy fall season and will end with the summer months. Thus, towards the end of June the lawyer will be in a position to determine whether or not he can afford to take full advantage of the "long vacation".

If the year end is January 15 or January 31 it will have the effect of deferring until the latest possible date the payment of each partner's quarterly income tax instalment.

Section 139(1)(r) of the Income Tax Act states that no change may be made in the usual and accepted fiscal period for the purposes of the Act without the concurrence of the Minister of National Revenue.

Financial Statements

Every partner in a law office, regardless of how busy the office is,

should insist upon receiving a financial statement each month. The financial statement should include the following:

- (a) Balance sheet
- (b) Revenue account
- (c) Statement of each partner's account
- (d) List of unpaid clients' accounts receivable showing age of each account and name of lawyer responsible for collection.
- (e) List of trust ledger balances, the total to agree with the trust bank account.
- (f) Reconciliation of each bank account with general ledger balance.

* * *

After perusing these comments and suggestions one can come to the obvious conclusion that a lawyer should now visit and criticize a busy accounting office.

Executive Compensation

JOHN G. McDONALD

SINCE THE ENACTMENT of s. 85A of the Income Tax Act in 1953 to deal with employee stock options there has been a general renewal of interest in the subject of "management incentives". The industrial manager of today who receives fringe benefits, such as an expense account and tax-free pension contributions, together with a promising stock option is clearly in an enviable tax position.

Progressive Rates of Taxation

Income tax rates now range from 13% of amounts below \$1000 of taxable income to 78% of taxable income in excess of \$400,000. In the "executive" salary range of \$10,000 to \$100,000 a year the marginal rates of tax are between 33% and 63%. The 50% mark is passed when taxable income reaches \$40,000.

Because salary costs are deductible in computing an employer's income, salary increases up to \$25,000 a year (plus the employee's exemptions) are in effect partially subsidized by the National Revenue. For example, a salary raise from \$11,000 to \$12,000 a year for a single man with no dependants results in an additional tax collection from the employee of \$330 and a reduction of tax collected from his corporate employer of \$470. The

Government "contributes" \$140 toward the raise. Net cost to the shareholders is \$530. As our rising executive rises further, however, the Government share of a \$1,000 increase is smaller. Between \$16,000 and \$26,000 a year in our example it is only \$40 a thousand. Beyond \$26,000 the Revenue is a net gainer — \$10 a thousand up to \$40,000, \$60 up to \$60,000, \$110 up to \$90,000 and so on up to \$310 a thousand at the top rate of tax.

It cannot be said that the burden of taxation at the middle ranges of income is unduly heavy, the *effective* rate at the \$25,000 level being less than 33%. Yet the impact of the high *marginal* rates, for example, 48% between \$25,000 and \$40,000, clearly dulls the incentive effect of salary increases offered to individuals in the middle income bracket. For this reason competing employers have in the post-war years broadened the use of non-salary forms of compensation in order to acquire and retain the services of key executive personnel.

Tax-Free Forms of Executive Compensation

(1) HIRING BONUSES AND COVENANTS NOT TO COMPETE

Before the Income Tax Act came

into force in 1949 hiring bonuses and payments for covenants not to compete could be used to put tax-free income in the hands of employees. It was essential, of course, that the payments should not be part of the consideration for the employee's services as employee. The hiring bonus was customarily paid as consideration for the executive's agreement to become an employee, and this was regarded by the courts as a capital transaction. Payments for covenants not to compete were normally used upon termination of employment, and were referable to the conduct of the executive after he ceased to be an employee. Here again there was no taxable income.¹

Since 1948, s. 25 of the Income Tax Act has provided for the taxation of such payments as income from an office or employment. A recent example of the application of this section to a hiring bonus appears in *No. 337*, 56 D.T.C. 224; 15 T.A.B.C. 73. In that case a \$250,000 payment had been made as consideration for the taxpayer's covenant to assume the duties of general manager of a corporation in which a corporation controlled by the payor had a substantial minority interest, and the payment was fully taxed in the year of receipt. However, s. 25 taxes an amount received by a taxpayer in satisfaction of an obligation arising out of an agreement made by the payor with the taxpayer immediately prior to employment of the taxpayer *by the payor*. Because taxpayer *No. 337* was never employed by the person from whom he received his hiring bonus it is arguable that s. 25 could not apply.

The only recent Canadian case

dealing with covenants not to compete indicates that s. 25 contains a serious loophole. In *No. 261*, 55 D.T.C. 285; 13 T.A.B.C. 23, the taxpayer had received a substantial sum in exchange for his covenant under an agreement entered into one month after termination of his employment with the payor. The Board held that s. 25 did not apply because the agreement was not made "immediately after" the employment period. It is surprising that Parliament has not seen fit to deal with this situation for future years by amendment of the section.

(2) EXPENSE ACCOUNTS

Although the expense account is a more prominent form of compensation in the United States than it is in Canada, it does have its place in the business world of this country. There is no doubt that a gap exists between legal theory and day-to-day tax practice as applied to corporation expense accounts. While recent decisions of the Income Tax Appeal Board dealing with entertainment expenses² are not directly relevant, they do indicate an apparent uncertainty on this subject on the part of the administration. For example, some taxpayers have been permitted to deduct entertainment expenses and some have not. In no known case involving a public corporation has any amount been included in computing an employee's income because a portion of the expenses resulted in his personal entertainment. On the other hand, assessments have been issued in cases involving the shareholder-directors of closely-held corporations.

¹ See *I.R.C. v. Lactagol Ltd.* (1955), 35 T.C. 230 and *No. 261*, 55 D.T.C. 285; 13 T.A.B.C. 23.

² *No. 262*, 55 D.T.C. 296; 13 T.A.B.C. 33, *Someran*, 55 D.T.C. 327; 13 T.A.B.C. 84, *No. 308*, 56 D.T.C. 31; 14 T.A.B.C. 237, *Decarie*, 56 D.T.C. 261; 15 T.A.B.C. 140.

The working rule today seems to be that if an expense is reasonable in amount and is incurred for a clear business purpose no portion of it is taxable as income to the employee who presides over its disbursement. The most glaring abuse of the rather liberal attitude of the Department of National Revenue is the "company car", and in time it may be expected that business vehicles used for personal pleasure will receive more diligent official attention.

(3) PENSION CONTRIBUTIONS

The exclusion of employer's contributions to a trustee under a registered pension plan from an employee's income together with the deduction of of an employee's contributions, under s. 11(1)(g) and (i) of the Income Tax Act, is particularly beneficial to employees in the middle income brackets. To an executive earning \$25,000 taxable income a year and contributing 6% of his salary to a pension trust to match his employer's 6% contribution, the pension provisions of the Act represent an annual tax saving of almost \$1500. This amount represents more than 18% of the tax that would be payable by him in the absence of s. 11(1)(g) and (i).

(4) STOCK OPTIONS

Before 1949 the law gave different income tax treatment to "market value" and "below market value" stock options received by employees. The market value option, that is, a right to purchase shares of the capital stock of the employer corporation within a future period at option-date market value, was not regarded as a form of compensation. Any profit derived from a sale of shares acquired under the option was a capital gain.³

Below-market options, on the other hand, created immediate income in the hands of the employee to the extent of the difference between market value and option price of the shares obtainable under the option agreement.⁴ It was not necessary that such an option should be exercised to create income subject to tax. Any profit attributable to appreciation of the value of stock acquired under the option was treated as a capital gain.

During the 1949-1952 taxation years the provisions of s. 25 of the Income Tax Act were probably broad enough to support the taxation of capital gains above option-date market value wherever the option was granted as compensation to an employee. There are no court decisions on this point.

Since 1952, s. 85A of the Act has required uniform treatment of all employee stock option benefits. Briefly, the rules are as follows:

(a) No tax liability arises when the option is acquired.

(b) A taxable benefit is deemed to have been received by the employee when the option is exercised

- (i) by the employee optionee, or
- (ii) by a person who has acquired the shares after acquiring the option from the employee through one or more transactions between persons not dealing at arm's length.

(c) A taxable benefit is deemed to have been received by the employee if he transfers or otherwise disposes of the option itself to an arm's length transferee, whether the transferee acquires the option directly or from a person who acquired it from the employee through one or more non-

⁴ *Weight v. Salmon*, 51 T.L.R. 333; 19 T.C. 174 (1935), No. 126, 53 D.T.C. 419; 9 T.A.B.C. 241.

³ No. 103, 53 D.T.C. 204; 8 T.A.B.C. 287.

arm's length transactions. The amount of the taxable benefit in this type of case is the value of the consideration for the disposition.

(d) The rate of tax applicable to the taxable benefit is the average effective rate of tax for the preceding three years (calculated as if net income were taxable income and excluding any stock option benefits or the tax thereon for any of the three years) minus 20. For example,

Assume three-years' income	
(single person)	\$45,000
Taxable income	\$14,000 a year
Tax is \$2,720 plus 38%	
of \$2,000	\$ 3,480
Total tax in three years ..	\$10,440
Total tax	\$10,440
.....	= 23.2%
Aggregate income	45,000
Applicable rate = 23.2% minus 20 =	3.2%

The rate applicable to a stock option benefit increases as income increases. For example, a single person earning \$41,000 a year pays tax on an option benefit at the rate of 17.4%.

(e) Employee stock option benefits, if taxable under s. 85A, are not taxable under any other provision of Part I of the Income Tax Act.

(f) Section 85A applies where a corporation has agreed to sell or issue its own shares or shares in a subsidiary corporation or other non-arm's length affiliate to an employee of the corporation or of its subsidiary or affiliate.

(g) An employer corporation, subsidiary or affiliate cannot deduct the cost of providing stock option benefits to its employees.

(h) If a trustee acquires shares absolutely or contingently for an employee, the employee is deemed to have acquired the shares at the time when the trustee acquired them.

(i) Where an employee "ceases to be an employee" before exercising an option or selling shares acquired under an option, s. 85A continues to apply as though the employment were still in existence.

(j) Section 85A does not apply "if the benefit conferred by the [option] agreement was not received in respect of, in the course of or by virtue of the employment" (s. 85A(7)).

The wording of s. 85A presents several problems, the solution of which will require litigation or amending legislation. Examples are:

Does the section apply to benefits received by an employee under an option agreement entered into before he became an employee? Probably it does not, in view of s. 85A(7) *supra*.

Does the word "transactions" in s. 85A(1)(c) and (d) include *inter vivos* or testamentary gifts? If so, option rights or shares acquired by gift or inheritance give rise to additional tax liability of the donor or decedent "in the taxation year in which [the donee or beneficiary] acquired the shares". In the case of an *inter vivos* gift of rights it can be expected that such an interpretation of the section is workable. But in the case of transmissions at death it becomes absurd. A beneficiary need only wait until the fourth year after death before exercising the option in order to establish a zero tax, zero income and zero rate of tax under s. 85A(2).

Does the word "transferred" in s. 85A(1)(b) include gifts? On the authorities it does: *Thomas v. Marshall* (1. of T.), (1953) 1 All E.R. 1102 (H.L.). It also includes loans⁵ and probably includes any form of hypothecation of option rights.

⁵ *Trinca*, 51 D.T.C. 91; 3 T.A.B.C. 354, *Quain*, 52 D.T.C. 200; 6 T.A.B.C. 278.

Does s. 85A(5)(a) exclude the operation of s. 8(1) in shareholder-employee situations? If so, substantial shareholders of closely-held corporations may be well advised to take *bona fide* employment with their corporations if they wish to substitute stock option benefits for taxable dividends. In the usual case the marginal tax advantage of the s. 85A credit over the s. 38 dividend tax credit is 15% of the amount of the corporate distribution.

A comparison of s. 85A with the United States "restricted stock option" (Internal Revenue Code §421) indicates that the Canadian treatment of employee stock option benefits is much more liberal than the American. United States taxpayers pay tax on their benefits at the capital gain rate of 25%. In addition, they must not sell their option stock within two

years of the date of option or within six months of the date of acquisition of the stock. Further, if the option price is below 85% of market value at the date of option the whole agreement falls outside §421. In addition, if the option price is below 95% of market value at the date of option the spread between market value and option price is taxable as ordinary income. The only advantage in the United States scheme of things appears to be the postponement of tax until the stock is sold.

As it now stands s. 85A of the Income Tax Act is the answer to the personal income tax problem of the executive group in our business community. Under favourable market conditions it can reduce the effective rate of tax upon high bracket income to a level below the lowest level imposed by the Act.

"AUTO" CLASSIFICATION

Automation — automative. I regret that those who coined these new terms did not include a philologist. The adjectival form "automative" provides a useful contrast with the colloquial use of the word "automatic"; but what of the verbal? Does one "automate" or "automatize"? I suggest the following classification of the words involved, though I cannot pretend to any canonical authority for doing so:

	<i>Traditional/Colloquial</i>	<i>New/Technical</i>
VERB TRANSITIVE	Automatize	Automate
ADJECTIVE	Automatic	Automative
ABSTRACT NOUN	Automatization	Automation

— From an address on "Automation" by The Rt. Hon. The Earl of Halsbury, F.R.I.C., F.Inst.P., *The Accountant*, July, 1956.

Profit Sharing Plans in Canadian Industry

G. O. HUGGAN

PROFIT SHARING has been defined as a procedure under which an employer pays to all his employees, in addition to good rates of regular pay, special current or deferred sums based not only on individual or group performance but on the prosperity of the business as a whole.

Profit sharing is an effort by the employer to increase the interest of his employees in the operation of the business by making them co-partners. The rewards of their combined effort are shared by both.

In his "Industry and Humanity" published in 1918, Mackenzie King wrote "If industry is to advance material and social well-being, which is its two-fold purpose, there must be continuous cooperation between all parties in the application of the principles underlying peace, work and health. How to obtain such cooperation is the supreme task. Fundamentally, it is a matter of attitude and spirit. Mutual trust born of whole-hearted belief in the common interests of industry must supersede the distrust which arises out of misgivings concerning opposed interests. Fear must give way to faith, in the several relations. There must be consciousness of a common aim in a com-

mon venture in which gains and losses alike are shared. The venture common to all in industry is the investment by each of some share of his life or fortune. The aim common to all is that each may render it much needed social service, and share as largely as possible in the joint product. Such a venture combined with such an aim is none other than a partnership. A partnership, in fact as well as in name, is what industry must become if its two-fold purpose is to be achieved with a maximum of goodwill and efficiency, and a minimum of waste of effort and materials. Partnership, to be worthy of the name, presupposes a willingness to share all along the line, to share in a knowledge and understanding of the enterprise as a whole, and of each other's rights and duties, *to share progressively in gains and proportionately in losses, and finally to share in the control and determination of policy.* If industry is to be conducted on a partnership basis, each of the contributing partners is entitled to share in all these particulars. If a genuine partnership can be so effected, its results cannot be other than beneficial and far-reaching."

Many industrialists have followed this line of thought in adopting profit sharing plans.

Background of Profit Sharing

Profit sharing in industry is not new. There is record of a profit sharing enterprise in England which introduced the principle in 1863 and today employs 3,000 people. The Industrial Co-Partnership Association, representing profit sharing businesses in Great Britain, has been functioning for 70 years. In the United States, interest in profit sharing has developed with the rapid expansion of business over the past half century. A recent survey shows that in the United States there are approximately 28,000 approved pension and profit sharing plans of which 8,000 are approved deferred profit sharing plans. It is estimated that new deferred profit sharing plans are currently being filed at the rate of 100 a month.

Some of the better known American profit sharing companies are Eastman Kodak Company, S. C. Johnson and Son Inc., Lincoln Electric Company, Motorola Inc., Pitney-Bowes Inc., Proctor and Gamble Company, Sears, Roebuck Company, Standard Oil Company of California.

Canada has not progressed as rapidly. There are about 150 deferred profit sharing plans today, of which 100 are "approved" and qualify as pension plans and 50 are "non-approved" deferred plans. There is, however, an increasing interest in profit sharing, due in part no doubt to the successful record of present profit sharing companies.

Recognized Canadian profit sharing companies include Canadian Line Materials Ltd., Toronto; Dominion Foundries and Steel Ltd., Hamilton;

Lincoln Electric of Canada Ltd., Leaside; Simpsons Ltd. and Simpson-Sears Ltd., Toronto; A. S. Nicholson and Son Ltd., Burlington; Supreme Aluminum Industries Limited, Toronto; Woodward Stores Ltd., Vancouver.

Council of Profit Sharing Industries

Although profit sharing had been practised in industry in North America since the turn of the century, it was only in 1947 that the non-profit Council of Profit Sharing Industries was formed. It began with 42 charter members; today it has more than 900. Its member companies represent a total of one million employees and do an estimated \$10 billion of business annually. Canada alone has nearly 100 member companies representing 100,000 employees. The first chairman in 1947 was James F. Lincoln, president of Lincoln Electric Company of Cleveland, Ohio. At the seventh annual conference held in Chicago in November 1954, H. V. Lush, president of Supreme Aluminum Industries Limited, Toronto was elected first Canadian chairman. He was re-elected for a second term at the eighth annual conference held in Pasadena in November 1955.

The council's national headquarters is in Chicago. Regional chapters with their own elected officers have been formed throughout the United States, and last year an Ontario chapter was established with headquarters in Toronto. M. N. Vuchnich, president of Lincoln Electric Company of Canada Limited, is its chairman.

At council meetings, members have the opportunity of discussing various phases of profit sharing. Individual plans may be discussed, each with its record of success and problems. Ideas are exchanged and the latest legisla-

tive developments reviewed. The national council has a full time executive secretary and staff who handle all enquiries and correspondence. Constant research is being conducted through the Profit Sharing Research Foundation and the results are distributed to council members.

Different Types of Plans

There is an infinite number of profit sharing plans and combinations of such plans. *The Profit Sharing Manual*, published by the Council of Profit Sharing Industries, lists the following main categories: cash, wage dividend, stock ownership, trust, combined cash and trust, guaranteed annual wage, production sharing, cost savings sharing, associative plans, co-operative plans and multiple management.

Cash Plans

Most plans fall basically into two general types, cash and deferred, or a combined plan which embodies the features and benefits of both. Cash profit sharing plans have these advantages:

(a) The receipt of cash, whether monthly, quarterly, semi-annually or annually, is forceful evidence of the results of profit sharing. For many employees, it is the only form of profit sharing which is appreciated. It gives them the chance to spend their extra earnings to improve their standard of living or provide some luxury not possible from current income.

(b) Cash distribution dramatizes to employees the current progress and prosperity of their company. Employees' interest can be effectively maintained when they sense their participation in the success of the company. Management has ample op-

portunity to present a dollar analysis of profit distribution, corporation income taxes, shareholders' returns, reserve funds for capital re-investment and expansion, and employees' share of profits.

Deferred Plans

Deferred profit sharing, where the share is paid to a trustee and held by him for future distribution to the employees, may have more appeal to some for these reasons:

(a) It provides security for the employee when operated as a retirement plan. Whereas fixed pension plans create a recurring overhead expense of definite proportion, a profit sharing retirement plan can fluctuate with the successful operation of the company up to a certain statutory limit.

(b) Where a pension plan is in operation, deferred profit sharing provides an excellent savings plan for employees who might otherwise dissipate cash payments. Reinvestment of these funds by the trustees adds to earnings. Usually a portion of the deferred profit sharing of resigning or dismissed employees is forfeited and increases the shares of continuing employees. Thus, even in no-profit years when no profit sharing may be available, there will be an increment in the individual employee balances through fund earnings.

(c) Loyalty in service is encouraged. Cash profit sharing payments are regarded as current payments, often soon spent and forgotten. Proper presentation of the employee's deferred profit sharing makes him more conscious each year of the savings fund accumulating to his credit. Most plans provide vesting after a

period of years. This gradual non-forfeiture over a period of years encourages employees to remain in the company's service in order to benefit from the full deferred profit sharing.

(d) There is also an income tax advantage to be considered. Funds paid out in cash are subject to personal income tax in the year received. Deferred profit sharing plans qualifying as pension plans gain the tax advantage accorded thereto. This is discussed more fully later.

One of the best solutions to the apparent conflict between the advantages of the immediate and deferred type of profit sharing is a combination of the two. This provides considerable flexibility and retains the best features of each. In a year of high profit sharing, management may distribute two-thirds in cash and place one-third in the retirement fund. In a poor year, the ratio may reverse. If the accent is on the retirement fund, it should be continually built up and the cash distribution curtailed when less funds are available. Other companies may feel that only a nominal amount should be allocated to the retirement fund in poor years because of the automatic increase through fund earnings.

Many factors enter into the choice of a profit sharing plan suitable for a particular company. Capital is entitled to a fair return just as employees should be paid the going rates of pay before any profit sharing is made. It is advisable that a formula be determined so that the employees may know the extent of their profit sharing participation. Most profit sharing companies commit themselves to a percentage distribution of profits, usually before income taxes.

Effect of Tax Legislation

Before a deferred profit sharing plan is adopted, some reference must be made to the effect of tax legislation on present-day plans. Many of the older plans now in operation contain some provisions that would not be approved today. In Canada there is a very minimum of pertinent legislation and regulations, and although this lack might be considered beneficial, it results in uncertainty as to what can be done and what is forbidden. Deferred profit sharing plans operate under two entirely different types of legislation in Canada. The first type may be classed as an "approved plan," i.e. one that qualifies as a pension plan and is formally approved by the Department of National Revenue. The second type may be referred to as a "non-approved plan"; it qualifies as a deferred profit sharing plan operating under section 79 of the Income Tax Act plus such amount as may be contributed under section 76.

Approved Plans

These qualify as pension plans and are the more common. Under section 11(1)(g) of the Income Tax Act an employer can contribute an amount not exceeding \$1,500 within 60 days from the end of the company fiscal year in respect of the services rendered by each employee. Under section 11(1)(i), which deals with employees' contributions to pension funds, the employee may contribute and deduct from his taxable income an amount not exceeding \$1,500 in the year for services rendered in that year which are actually paid into the plan, plus an amount not exceeding \$1,500 in respect of services rendered by him prior to the time he joined the plan.

The regulations governing the operation of the plans are outlined in the "Statement of Principles and Rules respecting Pension Plans for the Purposes of the Income Tax Act" published in June, 1950 and do not reflect legislative amendments since that time. Those referring specifically to profit sharing plans state that there must be a minimum guaranteed payment. The maximum contribution for one employee cannot exceed 15% of his earnings provided that such maximum contribution does not exceed 20% of the profits of the employer for that year. As the basic purpose of an approved plan is to provide pension benefits only, on retirement the employee's credits are to be used to provide a pension either out of the fund itself or through the Annuities Branch or an insurance company. The plan must provide for vesting in the event of termination upon reaching age 50 subject to a minimum period not exceeding 20 years of service or participation. Under the approved type, the employer's contributions are deductible as operating expense and the employee's contributions are deductible from his personal income. The earnings of the funds are exempt from tax until paid out. Income tax is payable on the benefit in the year in which received.

Non-Approved Plans

The second type of deferred profit sharing plan is that which operates under section 79 of the Income Tax Act. No approval is required. Many companies which cannot use pension legislation, as they already have a pension plan and are at the full statutory limits with respect to contributions, must be restricted to this section. The employee contributes a percentage of his earnings to a trust fund

and cannot deduct his contribution from his personal taxable income. The employer irrevocably pays a percentage of his profits to the fund. This amount is contingently allocated to the employee in proportion to his contributions or earnings or some other equitable formula. The earnings of the trust fund are not taxable to the trust. The employee receives annually a statement showing his contributions and the employer's profit sharing contributions contingently allocated to him as well as his accumulated share of fund earnings. He must pay income tax on that total amount in the year in which it is allocated. This imposes considerable hardship on the employee, who must pay income tax on funds not presently available and which may never be received. Most plans have a forfeiture in the event of employees terminating their service before completing a specified number of years of service. This present legislation of course discourages the adoption of this type of deferred profit sharing plan.

Profit Sharing Plan in Action — a Case History

Supreme Aluminum Industries Limited is a medium-sized manufacturer of aluminum cooking utensils with national distribution chiefly through hardware dealers. The company operates its own rolling mill and sells semi-fabricated aluminum circles, rectangles and sheet to other aluminum fabricators as well as supplying its own fabricating division. Normal staff is about 250. The president and general manager is H. V. Lush who, as mentioned before, is chairman of the Council of Profit Sharing Industries. After study of existing profit-sharing plans, the company discarded a standard pension plan in favour of a

deferred profit sharing retirement plan which was adopted on January 1, 1948. Each employee made contributions of from 3% to 5% of his earnings with a maximum of \$150 per year. Against this the company guaranteed 60% of the employee's contribution, maximum \$90, and from profit sharing from one to four times the employee's contribution, depending on available profits. Certain past service credits of older employees in the discarded standard pension plan were continued. In addition, substantial cash bonuses were distributed to all employees at an annual Christmas party.

So that employees would know the extent of their participation, the company adopted in 1951 a profit-sharing formula, "Pay the going rates to labour and to capital, then split the profits fifty-fifty". Constant review of going labour rates is carried out and any necessary adjustments are made. An interest return on capital investment is then provided for and the remaining profits are divided equally between employees and shareholders. Management determines the allocation between deferred profit sharing and cash profit sharing and submits this to the board of directors for approval. For a number of years merit ratings with bonus for rank, long service, category of job, good attendance

and punctuality were used to determine the point scores for distribution of cash profit sharing. At present cash profit sharing is being distributed in proportion to annual earnings, with penalties for excess absenteeism and lateness.

Distribution covers three different phases of service. At the Christmas party an interim cash distribution is applicable to everyone on the payroll in proportion to earnings for the year. The balance of the profit sharing distribution for the fiscal year, which ends December 31, is made the following March at the annual profit sharing dinner and benefits employees with more than one full year's service. The deferred profit sharing and retirement plan requires a waiting period of two years. Its members receive annual pass books which show individual accumulated balances and contain a complete financial statement of the retirement trust fund for the past year. While the company does not disclose the complete company financial statement to the employees, the company auditors report directly to the employees on their review of the profit sharing formula application.

The success of the profit sharing plan both from the standpoint of the employees and shareholders' retained profits can be judged by the extent of the distribution, as shown below.

Year	Retirement Fund	Cash	Total Profit Sharing
1948	\$ 50,280	\$ 23,105	\$ 73,385
1949	\$ 52,884	\$ 23,415	\$ 76,299
1950	\$ 69,860	\$ 27,910	\$ 97,770
1951	\$ 74,134	\$ 54,504	\$128,638
1952	\$ 62,281	\$ 75,408	\$137,689
1953	\$ 68,881	\$ 77,247	\$146,128
1954	\$ 50,978	\$ 65,353	\$116,331
1955	\$ 83,859	\$ 97,144	\$181,003
Total for 8 years	\$513,157	\$444,086	\$957,243

The retirement fund's trust fund, showing assets of \$606,000 at December 31, 1955, is administered by three trustees. Investments are confined to those eligible for life insurance company investments under the Canadian and British Insurance Company Act. Fund investments have earned better than 4%. Full retirement fund credit is received at normal retirement age (65 for men, 60 for women). Resigning or dismissed employees regain their full contributions with earnings and 50% of the company contributions and earnings. The forfeited 50% remains in the fund for re-distribution among remaining employees. As at December 31, 1955 the average member with eight years participation in the fund had a credit balance of \$7,850 after contributions of only \$1,200 himself. During that time he had also received \$2,925 in cash profit sharing.

The company has no union but the employees are represented by an elected plant council which meets with management at least quarterly to discuss company progress and mutual problems. To the fullest extent possible the employees are taken into management's confidence in discussing company operations and new ventures. An evidence of the low staff turnover is shown by the retirement fund membership which requires a two year waiting period; membership has increased from 40% of the staff in 1948 to 70% this year.

Conclusion

Profit sharing as practised by industry is still in its infancy in Canada. Members of the Council of Profit

Sharing Industries are devoting much time and effort to acquaint others of the mutual benefits to be gained in the acceptance of the philosophy of profit sharing and the desire to treat employees as co-partners. Briefs have recently been submitted to the Minister of Finance requesting an amendment to section 79, and other relevant sections, to permit deferred profit sharing plans to function properly. A submission has also been made to the Royal Commission on Canada's Economic Prospects on the importance of profit sharing to the Canadian economy. In his submission, Mr. W. D. Welsford, Chairman of the Legal and Legislation Committee of the Ontario Chapter of the Council of Profit Sharing Industries, mentions a few of the most commonly reported results of profit sharing. These are an increase in efficiency of production per employee, reduction of labour turnover, reduction in lateness and absenteeism, fewer or no strikes, increased earnings to stockholders and employees and increased cooperation between management and employees.

These advantages have all been realized by Supreme Aluminum Industries Limited in the eight years of operating its profit sharing plan. Much of the bitterness and strife evident in the relations between management and labour in today's industry may be overcome by more emphasis on teamwork. To maintain its respect and provide the leadership expected, management may be well advised to investigate more fully the possibility of applying the profit sharing philosophy to its own business.

Accounting Research

The Director
of Research, C.I.C.A.

CONFIRMATION CERTIFICATES AND LETTERS OF REPRESENTATION

(*Inventories, liabilities, and life
insurance policies*)

The practice of requesting confirmation of various matters during the progress of an audit is familiar to all auditors. The verification of bank balances, deposits of cash or securities with trustees, receivables, inventories, liabilities, insurance policies, tax arrears and other items is frequently supported by written confirmation.

Montgomery's *Auditing*, for example, points out that an inventory certificate "confirms statements made by the client as to the method of taking inventory, the ownership of the inventory, and the basis of its valuation, and avoids misunderstandings as to these matters between the auditor and the client. In addition, it reminds the client that the primary responsibility for inventory rests with him rather than with the auditor. The request for such a certificate is a customary procedure and in no way reflects upon the integrity of the client." (Montgomery's *Auditing*, 7th ed., pp. 215-6)

A warning may be added to Montgomery's explanation, to the effect that a certificate from the client (i.e. a letter of representation) merely supports the other audit procedures and in no way relieves the auditor from such other tests as the circumstances may require in order to place the

auditor in a position to formulate an independent and informed opinion.

The written confirmations obtained by the auditor are not all in the category of representations of management. The external confirmation, of either the "positive" or "negative" variety, is probably more familiar to the general public, and is sometimes of a very different quality since in some instances the external confirmation is the best available proof of the existence of an asset. In such a case the external confirmation is the key-stone in the audit arch for that asset; and this provides a contrast with the internal confirmation certificate which can be viewed as only one of the supporting pillars.

Professional accountants are well acquainted with the bank confirmation form approved by the Canadian Bankers' Association and the Canadian Institute of Chartered Accountants. For many years printed copies of that form have been available at the office of the Canadian Institute. Accountants are accustomed also to the use of rubber-stamp or printed sticker notices for use on accounts receivable statements in either positive or negative confirmation of receivables. Such rubber stamps or printed notices are devised by each firm of auditors to suit its own purposes. For the confirmation of other matters the auditor has drafted forms as circumstances required, and some of the larger firms have had the certificates

printed to meet their needs. Accounting texts supply illustrations of confirmation forms for some purposes, but the auditor who is looking for a suitable form will have difficulty in finding many useful examples, especially in respect to Canadian practice.

The Canadian Institute of Chartered Accountants' Committee on Accounting and Auditing Research has been conducting a study of the forms used by several firms of chartered accountants in the confirmation of inventories, liabilities, and life insurance, these being the items (in addition to bank balances and receivables) most frequently subjected to written confirmation. In the course of this study a series of forms has been drafted and re-drafted and subjected to critical review from time to time by members of the committee. By this process, forms were gradually developed which seemed ultimately to occasion very little, if any, criticism; whether this is by virtue of the excellence of the forms or the exhaustion of the critics is now not too clear.

The committee has approved publication of the three forms shown below as examples of confirmation certificates which would be useful in many cases but which would need revision to meet special circumstances, and which are not claimed to be any more suitable than many forms that may now be performing the same or similar functions. There is no thought that these should be viewed as "official" forms, or that they should be presumed to carry any special sanction; nor is there any thought at this time that they should be made available by the Canadian Institute in quantity for use in practice. Instead, they are offered only as suggestions

which may be helpful to those practitioners who wish to make use of them, either in the present style or as adapted to individual needs. Comments and criticisms will of course be welcomed.

Some reference to matters of detail in the certificates may be in order.

The Inventory Certificate

The quotation from Montgomery emphasizes the method of taking inventory, the basis of valuation and the ownership of the goods. These points are brought out in sections 1, 2 and 4 respectively in the draft form of inventory certificate. Section 4 relates not only the facts of ownership title, but also the status with respect to associated debt or other obligations such as the existence of sales commitments below inventory valuations. In section 2, the column headed "Basis of Valuation" has an explanatory note indicating that the description of the basis of valuation of each division of the inventory should include a designation of the method of determining cost, that is, whether cost has been measured according to *Fifo*, *Lifo*, average, or other procedures. Even if this information is not disclosed in the financial statements the auditor will require it in the formulation of his opinion as to the statements.

Section 3 of the inventory certificate relates to allowances for goods which have depreciated in value. This section will be very important in those cases where the goods are not valued at the lower of cost or market, but even where the goods are ordinarily valued at market where that is below cost, "full allowance" for deteriorated stock may call for further allowance if valuation at market is not reasonable. In any case the wording

INVENTORY CERTIFICATE

of _____

as at _____ 19 ____

TO: Messrs. _____, Chartered Accountants.

In connection with your examination of the financial statements of the above company as at _____ 19 ____, we certify that, to the best of our knowledge and belief:

1. The Company's inventories as summarized in Item 2 are correctly stated and were ascertained by actual count, weight or measurement except for the following: _____

2. All values were determined on the same basis as in the previous year, namely:

Classification	Basis of Valuation (including the method of determining cost)	Amount
_____	_____	\$ _____
_____	_____	_____
_____	_____	_____
_____	_____	_____
Total	_____	\$ _____

3. Full allowance has been made for slow-moving, unsalable, defective, deteriorated and obsolete stock.

4. The cost of all goods contained in the inventories was properly recorded in the books of the company as at the above date; the inventories included no goods held on behalf of others or goods invoiced to customers; and the goods included in the inventories were the property of the company, free from all liens, encumbrances, and sales commitments below inventory prices, except as here noted:

_____	_____ (signed)	_____ (title)
_____	_____ (signed)	_____ (title)
_____	_____ (signed)	_____ (title)

Date _____

emphasizes the fact that deteriorated goods are not to be valued as normal stock.

The Liability Certificate

The liability certificate is designed to draw out information not only as to the direct liabilities of the client, but also as to indirect liabilities and extraordinary commitments of all types (including such things as options on the capital stock of the company) and information as to the pledging of assets as security for debts. Very often the recording of some of these circumstances falls outside of the client's regular bookkeeping procedures, and the liability certificate consequently is a most important part of the process of ascertaining the facts.

The Life Insurance Certificate

The life insurance confirmation form has been drafted in a form similar to that of the standard bank confirmation form. Like the bank form, it is an external confirmation, and should be sent out in duplicate so that the insurance company will have one completed copy for its files. The "original" may be shorter than the "duplicate" copy, the top of the "original" being at the broken line shown in the illustration. The two copies may be separate sheets or parts of the same sheet of paper folded and perforated at the margin on the left. A simplified form, in which the original and duplicate are exactly the same size (with the authorizing request being shown on both copies), should be equally satisfactory.

In drafting the life insurance confirmation form an effort has been made to keep the requirements to a minimum, in recognition of the fact

that the insurance company is being asked to complete the document. If further information is needed, the form should be extended by inserting the additional items after item 5.

Before he sends out the duplicate form the auditor should insert this information in the spaces provided:

- (a) Name and address of the insurance company.
- (b) Name and address of the auditor.
- (c) Policy number.
- (d) Name of person whose life is insured.
- (e) Name of the client.
- (f) Date up to which transactions are to be included. (This will be the date of the client's balance sheet.)

The insurance company will fill in the information and dates of items 1 to 5. The dates shown for cash values and other matters may differ slightly in some cases from the client's balance sheet date without materially affecting the results.

The Canadian Life Insurance Officers Association has cooperated generously in the drafting of the insurance confirmation form, and the Committee on Accounting and Auditing Research is grateful for that help, and especially for the valuable assistance of the Reviewing Committee and of the Secretary and Actuary of the Association, Mr. Bruce R. Power, F.S.A.

At the risk of being repetitive, the C.I.C.A. Research Committee wishes to emphasize that the illustrations are intended only as examples of forms deemed suitable for their purpose, and that changes to suit circumstances will sometimes be desirable.

Offprints are available on request from the C.I.C.A. office.

Accounting Research Bulletin No. 12 lists A. P. Smibert as a committee member. This should read Alfred Smibert.

LIABILITY CERTIFICATE

of _____

as at _____ 19 ____

TO: Messrs. _____, Chartered Accountants.

In connection with your examination of the financial statements of the above Company as at _____ 19____, we hereby certify that, to the best of our knowledge and belief:

- (1) All liabilities were correctly recorded in the accounts as at that date.
- (2) There were at that date no contingent liabilities in respect of bills discounted, matters in suit or in dispute, guarantees or other matters, nor any options or commitments (other than normal commitments entered into in the ordinary course of business) except as hereunder stated:

- (3) No assets of the Company have been pledged as security for liabilities, except as follows:

(signed)_____
(title)_____
(signed)_____
(title)

Date _____

(signed)_____
(title)

Form to be sent in duplicate by the auditor to the Insurance Company's Branch Office at which premiums are paid. Duplicate copy to be retained by the Insurance Company. Original to be returned to the auditors named below.

Dear Sirs: _____ 19 ____

We shall be obliged if you will kindly complete the attached report and mail the "Original" section, in the enclosed addressed envelope, direct to the auditors named below.

Yours truly,

By _____

Authorized Signature

ORIGINAL LIFE INSURANCE CONFIRMATION FORM

Report from
(Insurance Company) _____

Name of auditors:

Dear Sirs:

Re: Policy No. _____

On life of _____

Audit client _____

We report that the records of this company, including transactions to _____ 19 ____, show:

1. Face amount of policy \$ _____
2. Date to which premium paid _____ 19 ____
3. (a) Cash surrender value at _____ 19 ____ \$
- (b) Add accumulated dividends and interest or cash
 value of paid-up additions _____
- (c) Deduct indebtedness against policy — Policy
 and automatic premium loans, including
 interest at _____ % accrued to _____ 19 ____
 Net cash value \$ _____
4. Name of beneficiary _____
5. Name of assignee, if the policy has been assigned _____

Yours truly,

Date _____ (Insurance Company) _____

By _____

Authorized Signature — Title

Practitioners Forum

ACCOUNTS RECEIVABLE CONFIRMATIONS

Printed form letters for "negative" or "positive" confirmations are standard equipment in every auditor's work chest. However, many minor differences in wording are found. Are these significant? What is the "best" wording? Differences in mechanics are likewise found. There are rubber stamps, labels for glueing or stapling, printed letters bound in pads or loosely bundled. Sizes range from small, which fits an envelope with one fold, to regular or letter size. From all the varieties possible, how should one go about making a choice for one's own use? Here are a few samples

and a sprinkling of observations from fellow practitioners.

Specimen Wording

Should verifications be worded to coax a reply from the debtor or should they be kept brief and to the point? The following specimen forms illustrate the two extremes. The first is used specially for credit union members who probably are not too conversant with audits. It is printed beneath the accountant's letterhead on a small sheet requiring one fold to fit a window envelope. The second is printed on a label gummed all over. The envelope enclosed with it is not stamped. Note that both are "positive" requests.

DEAR CREDIT UNION MEMBER:

The records of your credit union show the following balances in your account as at Additions to shares and deposit accounts or withdrawals and payments on loans after this date have not been taken into account in arriving at the balances shown.

You have in shares	\$
You have on deposit	\$
You owe in loans	\$

Payments on your loan are instalments in arrears.

PLEASE SIGN THIS LETTER AND RETURN IT TO US in the enclosed addressed envelope. If for any reason the amounts are incorrect we would appreciate a full explanation, which can be given on the back of this letter.

This request is made for audit purposes to locate and correct any errors. As a credit union member you will appreciate the importance of adequate records, and that audits are carried out to safeguard your interests. It is essential that all members' accounts be checked and your cooperation in replying promptly will be appreciated.

Yours sincerely,
(Name of Firm).
Auditors

I certify that the above amounts are correct:

Date Signature

FOR AUDIT PURPOSES ONLY

Kindly compare this statement with your records and indicate thereon, over your signature, whether or not it is correct, giving particulars of differences, if any; then send it DIRECTLY to our AUDITORS —

(Name of Firm)

An addressed envelope is enclosed for your convenience.

Comment

Robert E. Waller, C.A. of Calgary comments as follows:

"I prefer the type of form that is brief and direct rather than one worded with special emphasis on coaxing a reply from the debtor. I believe that standard forms prepared with this principle in mind are suitable in most instances. However, if a particular group of debtors are perhaps unaccustomed to receiving requests for confirmation of balances, special forms may sometimes be prepared by the client, in which reference is made to subsequent payments or other enlightening explanations are given.

"In designing a form, the principal points to bear in mind are that a request for confirmation should be as

clear and concise as possible and should indicate that it is being made for audit purposes.

"On the form which requests a reply only if the balance is incorrect, a notation that 'if no differences are reported the statement will be taken to be correct' has some psychological value. Further, it might be observed that some firms consider it good practice to indicate that the form is not intended to be a request for payment of the account."

More Specimens and Comments

For the type of request that requires an answer only if there is a difference, the firm with which Mr. Waller is associated uses a leaflet 4" x 2½" with wording as follows:

FOR AUDIT PURPOSES

Kindly compare this statement with your records and if it is not in exact agreement therewith send it, together with particulars of any differences, *directly* to our auditors:

(Name of Firm and Address)

If no differences are reported, the statement will be taken to be correct.

This is stapled to a copy of the client's statement; previously, it was gummed at one edge, but was apt to become detached from the statement.

For requests that require a reply as to whether or not the balance is in agreement with the debtor's records, this same firm uses a form 8½" x 11" with wording as shown at the top of the next page.

Another prominent accountant,

agreeing with Mr. Waller, says: "I think that a verification form should be carefully worded to make clear the auditor's position in the case and the purpose of the request. It should do credit to a professional man and be easy to understand. My personal preference is for the concise sticker rather than the credit union sample. I feel that the last paragraph on that sample, except for the first sentence,

Dear Sir/Sirs:

For the purpose of obtaining independent confirmation of accounts receivable, we are asking customers to confirm the balances of their accounts with us as at direct to our auditors, (*Name of Firm*).

Your account at the close of business on that date shows an unpaid balance against you of \$.....

We shall be obliged if, after comparing the balance with your records, you will sign the confirmation below after noting thereon your exceptions, if any, and return it to our auditors in the enclosed stamped addressed envelope.

This letter is not intended to be a request for payment of your account.

Yours very truly,

(Signed)

by

CONFIRMATION OF ACCOUNTS RECEIVABLE

(*Name of Firm*)

(*Address*)

Reference

Number

Dear Sir

The debit balance of \$..... is correct at except as noted below: (Please list any differences showing dates and amounts).

Charges we do not accept:

Credits we have not been allowed:

Other differences

(Signed)

Date 19

By

is overdoing it somewhat. On the other hand, the alternative given is not satisfactory because it does not provide a place for the customer to sign."

Some forms also state prominently: "All transactions since the above-mentioned date have been disregarded in arriving at the balance shown". This, no doubt, will tend to reduce the number of "differences" reported due to subsequent payments not yet credited.

Form and Technique

The following remarks by Wm. L. C. Wallace of Vancouver cover some points on technique:

"We prefer a sticker to a rubber stamp for negative confirmations. It is much neater and it does not present

a problem where a statement has very little room left on it for placing an impression. We chose yellow stock and large type to draw attention to the notice. While we were aware that many firms use a more lengthy narrative, we believe that the same purpose is accomplished with the shorter form.

"Special forms are used on some larger audits. On one, for example, the client runs off the letters on its multilith machine, using the auditors' letterhead. Only the amount has to be typed in. The customer's name is not inserted, as a copy of the statement is attached. There is also a self-addressed, stamped envelope enclosed, but we feel there is no need to mention it in the letter. Each letter is numbered on the back by a numbering machine and the same

number is placed opposite the customer's name on the accounts receivable list. As the letters come back, they are identified by number and checked off. There is a follow up where we consider it necessary."

Another useful technique is to have "positive" forms padded on white and yellow paper alternately. Padding keeps them together before use and reduces waste. They are typed in duplicate, the white original is mailed and the yellow carbons filed. As replies come in, they are filed in order and the matching carbons destroyed. The file then contains a complete record of confirmations mailed; those not returned are indicated by the yellow copies, without any special listing. If second requests are considered necessary the yellow copies can be mailed.

Response

Generally, confirmations are an accepted part of business procedure and a satisfactory response is obtained. Sometimes, however, a need exists for educating the recipients. The American Institute of Accountants has published a leaflet with this in mind. It is small enough to be conveniently enclosed with confirmation notices. Quantities are available at reasonable cost. Entitled, "Please check your account — a request for your cooperation from the C.P.A.", the pamphlet reads as follows:

"This leaflet accompanies a statement of the balance of your account with a business firm and a request that you check the correctness of the statement for the information of a certified public accountant in his capacity as independent auditor.

"This request is not a means of urg-

ing you to make payment. The certified public accountant is neither a bill collector nor a credit man.

"The CPA is making an independent audit of the concern with which you have the account. Such an audit, at periodic intervals, is standard business procedure. The best way the CPA can learn whether your account is correctly stated on the books of the concern is by checking with you.

"By cooperating with the CPA in meeting the request —

You protect yourself against any accidental misstatement of your account in the company's records which might later cause you annoyance.

You protect the owners by making it possible for the certified public accountant to check the condition of the books and records of the company.

You protect employees of the company by furnishing evidence that they have kept the accounts accurately.

You render a public service. Banks which lend money to the company, stockholders of the company, investors who may buy its securities, want the opinion of an independent certified public accountant on the company's financial statements. These include accounts receivable, which are often a large part of a company's assets.

"The certified public accountant's job is to get at the facts — and in this he needs your help. Sometimes you are asked to advise him whether or not the balance shown is correct. Other times it is considered sufficient to request that you advise the auditor only if you believe the balance is incorrect. In either case your cooperation will help the company to maintain a sound credit standing and aid the orderly conduct of business."

The Tax Review

INCOME FROM OFFICE AND EMPLOYMENT

The income from a business, it is well established in income tax law, is the difference between the proceeds therefrom and the cost of earning them, though there are special rules to determine what are such costs. In the case of income from offices and employment, however, a different principle applies. Subject to specifically enacted exceptions, the income from an office or employment is the gross proceeds therefrom. In other words, there are no allowable deductions except those specifically described in the statute.

What is an office or employment? The Act defines "employment" (s. 139(1)(m)) as the position of an individual in the service of some other person, and "office" (s. 139(1)(ab)) as the position of an individual entitling him to a fixed or ascertainable stipend or remuneration . . . and "officer" includes the director of a company.

A question which has plagued the Income Tax Appeal Board almost since its inception is that concerning the status of professional entertainers, such as singers, radio performers and the like, who enter into a series of professional engagements during a taxation year. Each separate engagement constitutes a separate contractual arrangement, and usually in each of them the impressario retains a measure of control over the performer

and the performance. For income tax purposes the question then arises whether the entertainer is engaged in a "calling" which is a business for income tax purposes (see s. 129(1)(e)), or in an employment within the meaning of the statutory definition. In the Income Tax Appeal Board (and so far none of these cases has gone to a higher Court) the answer has in the great majority of cases been that each of the entertainer's separate contracts creates a separate "employment" with the consequence that none of the entertainer's expenses (which are naturally high by reason of the nature of the occupation) are allowed to be deducted.

This very question long since came before one of the greatest of English income tax judges, Mr. Justice Rowlatt, in the case of *Davies v. Braithwaite*, 18 T.C. 198, where that learned Judge defined the issue as this: did the entertainer's engagements, when looked at all together, form an organic whole, which was properly to be described as the carrying on of a vocation? If so, it amounted to a business. Regrettably, this approach has so far not yet been adopted by our Income Tax Appeal Board.

After all, one may say, such tradesmen as barbers and plumbers carry on their occupations by entering into a series of engagements, and in many cases their customers exercise a large measure of control over the performance. Yet surely no one would argue

that a barber is in the "employment" of his customer within the meaning of the quoted word as defined in the Income Tax Act so as to be debarred from writing off the expenses of his occupation. Similar is the case of a person whose income derives from commissions earned as a sales agent for a number of manufacturers. Each of his agency contracts may reserve a large measure of control to the principal, yet no one would suggest that the agent is not engaged in the carrying on of a business. What, however, is the position of a life insurance agent or other commission salesman who is employed by one principal only? Is he in "employment" or does he not rather follow a "calling"? In the former case he is subject to the much narrower rule of allowance than in the latter.

Fortunately, many problems of this kind have been minimized, if not eliminated, by special provisions of the statute. For example, the Act specifically declares that a person employed in connection with the selling of property or negotiating of contracts who receives an allowance for travelling expenses from his employer is not subject to tax thereon (s. 5(1)(b)(vi)). A similar rule applies to the travelling expenses of other officers and employees (s. 5(1)(b)(vii)). If, however, a salesman (that is a commission salesman) does not receive an allowance for his travelling expenses but pays his own expenses he is entitled to deduct *all* expenses (not merely travelling expenses) incurred by him in the earning of his commissions during the year. In other words he is in virtually the same position as a person deemed to be carrying on business, with the main exception that he may not avail himself of the loss carry-over provi-

sions of the Act and, one gathers, may not apply the losses from one agency against the profit from another in the same year.

Officers and employees, other than commission salesmen, who are required to pay their own travelling expenses in the performance of their duties are also entitled to deduct such expenses if they receive no allowance therefor from their employers. Note that unlike commission salesmen it is only travelling expenses which may be deducted, not all expenses incurred in earning their income (e.g. entertainment expenses) (s. 11(1)(q)).

Since 1954, a commission salesman or other officer or employee who is entitled to deduct travelling or other expenses incurred by him is prohibited from claiming the cost of a meal unless he was on a trip of more than 12 hours duration (s. 11(9a)).

Apart from travelling expenses and the expenses of commission salesmen, the following are the only additional expenses permitted to officers and employees (s. 11(10)):

- (a) annual professional society fees;
- (b) annual trade union dues (whether the taxpayer was a member or not);
- (c) office rent paid by the taxpayer;
- (d) salary paid an assistant or substitute by the taxpayer;
- (e) the cost of supplies consumed in performing the taxpayer's work.

In addition, officers and employees, including commission salesmen, who are entitled to deduct travelling expenses in reporting their income, are expressly allowed to claim a capital cost allowance on the cost of a car used in the course of the office or employment.

There are a great many expenses

which remain non-deductible to an officer or employee. For example, the president and controlling shareholder of a trading company cannot claim as a deduction in reporting his personal income the cost of entertaining his customers. In such a case, the problem can, of course, be readily solved: the expense can be charged to the company and the president's outlay be treated as made on behalf of the company. The same procedure can be followed in other cases as well. For example, a physician employed

by a municipal corporation may pay his professional society fees and claim the amount as an expense in reporting his income. If the municipal corporation pays the fees, the question will arise whether such payment is chargeable as income to the doctor as being a "benefit received or enjoyed by him in the year in respect of, in the course of or by virtue of the office or the employment" (s. 5(1)(a)). The answer is one of persuasiveness.

ON WRITING BRIEFLY

The thing needed in writing is to have something to pass along, and to use words the reader will understand, put up in packages small enough for him to grasp easily. When your writing is definite in its manner and plain in its language it is likely to be vivid, so that your words walk up and down in the mind of your reader. Brevity helps you to give movement to what you write.

All of us would like to write letters and reports and articles that have distinction of expression, brevity, dramatic quality, concreteness, beauty of rhythm and adventurousness of phrase and idea. We can do it. By paying attention and observing a few principles we can improve our writing little by little until one day we awake to the realization that we have achieved the mystery called "art".

If you write long sentences, look for joints in their construction where you can break them into smaller pieces. The more words there are in a sentence the harder it is to read and understand that sentence. Let us cut sentences into bites we can swallow. The man who wishes to avoid suspicion of being a fuzzy thinker will prune his high-sounding phrases. Instead of adorning one thought about his firm or his product or himself in ten glorious sentences, he will fill ten simple sentences with ten significant thoughts.

John Evelyn the 17th century diary writer, told the story of Monmouth's rebellion in 68 lines, and he included all essentials and colour. Homer condensed ten years of adventure into his epic *Odyssey*, and Aristotle made a digest of it in 79 words. Lincoln's address at Gettysburg used only 266 words. The Ten Commandments use 297. The United States Declaration of Independence has 300. By contrast, said Walter Winchell, the United States columnist, a U.S.A. order to reduce the price of cabbages used 26,911 words.

— *The Royal Bank of Canada Monthly Letter*, July 1956.

BY PETER C. BRIANT, B.COM., C.A.

Current Reading

Assistant Professor,
McGill University

MAGAZINE ARTICLES

ACCOUNTING

"THE IMPORTANCE OF THE TIME FACTOR IN INVESTMENT DECISIONS", by C. G. Edge. *Cost and Management*, June 1956, pp. 211-223.

One of the most important pieces of knowledge for an accountant to bear in mind is that the promise of a dollar tomorrow is not worth a dollar today, and that today's dollar was not worth a dollar yesterday. In other words, money should always be regarded as earning interest.

Utilizing this time-honoured concept and drawing upon his knowledge of economics, Mr. Edge demonstrates what he calls "the discounted cash flow method" of measuring return on investment. It amounts, in effect, to calculating the maximum discount rate which can be applied to all future net receipts so as to make their sum equal to the initial expenditure.

Mr. Edge is quite correct when he admits that the method is not new, and he is on equally strong ground when he says that it is not widely known or used. In the past, difficulty has arisen in the application of the method because of the uncertainty attached to the meaning of the words income and expenditure. It is here, by relating cash outflow to cash inflow through the rate of interest and rejecting income and expense comparisons, that he has made a significant contribution to the literature on the subject. As he points out, the

prime reason for embarking on new projects is the expectation that subsequent cash receipts will exceed cash disbursements and yield a satisfactory return on the outlay. It follows logically, therefore, that if one accepts the hypothesis at the head of this commentary, the two flows should be compared at one point in time. Other methods of evaluating a projected investment or of comparing competing alternatives do not do this. Relating average annual net income over the life of an asset to the average investment required overlooks, for example, a variable income pattern, giving no more weight to high income in early years than to low income in late years.

The mechanics of computing the rate of return on investment by the "discounted cash flow" method are extremely simple, and may be readily understood by anyone possessing a rudimentary knowledge of financial mathematics.

AUDITING

"FOOTNOTES IN FINANCIAL STATEMENT PREPARATION", by Clayton L. Bullock. *Journal of Accountancy*, July 1956, pp. 39-44.

The proper disclosure of financial information essential to the reader of financial statements may be effected in the statements themselves, in footnotes to the statements, or in the auditor's reports. This article, which should be on the required reading

list of every student, is concerned with items falling within the second group.

The author carefully stresses that any similarity between footnotes and qualifications in the auditor's report is more apparent than real. He admits that both are means by which the auditor assures himself that information not presented in the financial statements is nonetheless adequately disclosed, but asserts that there the similarity ends. Footnotes, he writes, constitute disclosures by the management of the company, whereas qualifications or exceptions in the report represent disclosure by the certifying auditor. A qualification in an auditor's report may indicate disagreement between the management and the auditor as to the interpretation or presentation of the company's financial statements, whereas a footnote is more likely to indicate agreement between the two.

With a footnote defined as "a disclosure by management of pertinent information which it is not feasible or customary to incorporate in the statements themselves", Mr. Bullock develops and illustrates their nature within the following framework:

1. Footnotes to disclose financial data not included in the statements:
 - a) To simplify the structure of the statement (e.g. contingent liabilities).
 - b) To clarify where there is uncertainty as to the amount involved and where direct provision in the statement is not only difficult but undesirable (e.g. provision for federal income taxes where the amount is in dispute).
2. Footnotes to provide accounting information which may be necessary to interpret the statements properly:
 - a) Those having to do with the application of accounting principles

(e.g. a change in the method of providing for estimated bad debts).

- b) Those relating to disclosure of commitments (e.g. unusually large purchase orders for future delivery).
- c) Voluntary footnotes on the part of management to enable readers to interpret statements properly (e.g. the method of reporting income from deferred or instalment contracts).
3. Footnotes to disclose extraneous matters essential to the readers of the statements — a category normally confined to the disclosure of post balance sheet events.

EQUIPMENT

"PLAN YOUR COMPUTER INSTALLATION WITH MAXIMUM ADVANTAGE" by T. V. Learson, *N.A.C.A. Bulletin*, July 1956, pp. 1311-1316.

Drawing upon his wide experience in the field of business equipment, the author attempts to clear away some misconceptions he believes are prevalent in the current literature dealing with accounting applications of electronic equipment.

The advice tendered may be summed up as follows:

1. Do not convert manual methods directly to electronics.
2. Do not transfer tabulating procedures without revision.
3. Have experienced men review programs.
4. Have a single team handle all the conversion steps, from the preparation of the flow chart to the machine programming.
5. Do not handle rare exceptions electronically.
6. Select the computer staff with care.

Each of these items is elaborated on in the body of the text. The careful selection and assignment of personnel for data processing staff appears to Mr. Learson to be the most important factor. He would first have management convinced that the future im-

pact of electronics justifies the assignment of the best men possible to direct the work. The selection process would emphasize the aptitude rather than past performance, and would preferably be on the basis of personal interviews. To meet Mr. Learson's standards, the people selected should possess logical minds and should demonstrate an interest and ability in problem solving. Furthermore, they should be thoroughly aware of the importance of systems analysis and of the opportunities in the field.

FINANCE

"THE FINE ART OF RAISING CAPITAL" by Charles E. Silberman. *Fortune*, July 1956, p. 97 et seq.

This article, which is the fifth in a series on financing, considers the various techniques by which a corporation may borrow money or sell stock, a comprehensive discussion of debt versus equity financing having appeared in the June issue of *Fortune*.

Once it decides to borrow, writes the author, a company faces its first pitfall when it ponders whether to borrow short or long-term. The past year, for instance, has witnessed a refutation of the popular axiom "stay short as long as possible", with rates on prime commercial paper and bank loans moving above long-term rates.

Further problems arise in timing an issue. Mr. Silberman reports that one U.S. corporation could have saved \$60,000 in annual interest charges had it sold \$30 million of debentures two weeks earlier than it did. The experience of another U.S. corporation, that issued 300,000 common shares at \$53 each, an all time high, only to find the price rise to the mid-sixties two months later, underscores even more

pointedly the bewildering turbulence of the present capital market.

MANAGEMENT

"LONG-RANGE PLANNING" by Robert C. Tait. *The Controller*, July 1956, p. 307 et seq.

What criteria should be employed to measure or evaluate long-range plans, to establish priorities among different plans, or to accept or reject a plan? Writing on this subject, Mr. Tait, a company president, states that in his own firm a return of about 20%, before income tax, on gross assets employed is the acid test. But the relative stability of a project and the extent to which a given project supplements present market lines are also considered. Thus, in Mr. Tait's company, unstable short-term projects are required to indicate a return in excess of 20%, while projects promising a long and successful life are acceptable even though they may offer a return of less than that figure. This would appear to be a reversal of the normal doctrine unless the stability feature is emphasized.

Discussing the scope of long-range planning, Mr. Tait stresses the need for evaluating all other data against the backdrop of general business conditions. The development of such data in recent years by government, banks and private agencies has now made it feasible for any manufacturing enterprise to plan five years ahead, he says. In consequence he lists the responsibilities of a central planning department as follows:

1. Study of business conditions and forecasting with respect to the general economy.
2. Market analysis and research . . .
3. Determination of capital budgets and long-range appropriations on the basis of gross investment.

4. Redetermination of product line goals that will fit into the overall company pattern of availability of capital facilities, engineering, and technical manpower. . . .

PROFESSIONAL

"COMPETITION FOR THE ACCOUNTING GRADUATE", (editorial) *Journal of Accountancy*, July 1956, pp. 25-26.

According to the report of one major U.S. University, starting salaries for graduates with a major in accounting are said to have increased by 5.1% between October 1955 and May 1956. Industrial firms reportedly paid 3.6% more for accounting majors this spring than last fall.

The editorial observes that higher starting salaries will not alone increase the supply of able students entering into public and private accounting; nor does it think that merely talking and writing about the opportunities and satisfactions of an accounting career are enough. Both industry and the profession are therefore admonished to demonstrate effectively that the opportunities and satisfactions inherent in a successful career are actually in sight of accountants with exceptional ability, within a short time after graduation.

BOOK REVIEW

Income Tax for the Layman (3rd ed.). The Central Board of Revenue, Civil Lines, Delhi 8, India. Rs. 1/12/- (35c)

This book, written in English, is addressed to the "ordinary taxpayer" in India. It has passed through two earlier editions of 10,000 copies each, and only with this 1955 edition of 5,000 copies is it announced that a Hindi version of the same number is being prepared. So the average Indian taxpayer still speaks English, but per-

haps the Hindi version is a sign of change.

This government publication is very readable and succeeds in presenting to the layman the essential particulars of a complex subject. Distinctive features are the various charts and graphs which are intended to give pictorial expression to matters of particular interest. Some of them, it is true, seem unnecessary substitutions for simple statements of figures. This certainly applies to the frontispiece, which purports to indicate for different areas of India the total collections and number of assesseees in 1953-4. Such a chart seems in any case useless without a uniform scale for comparison. Other charts, however, are useful simplifications, as in the case of one depicting at a glance the channels of appellate and revision procedure.

Best of all is the chart which gives a series of curves of ten different countries, including Canada, to show in comparative form the incidence of tax in relation to income for a man with a wife and two children. Canada, the United States and South Africa are immediately seen to be in a class apart from all others for the relative lightness of the burden of tax on individuals. After the \$20,000 income level the percentage of tax is clearly heaviest of all in the United Kingdom and lightest in the United States, with Canada next in lightness.

From a concluding chapter on the general burden of income tax it appears that India exempts income from agriculture. The first five years profits of new undertakings are also exempted, up to 6% of the capital employed, together with dividends therefrom in the case of limited companies. The comparative poverty

of India's millions explains why its rate of tax on the first \$1,000 of taxable income is only 4.9%, which becomes 88½% after \$30,000, while Canada's is only 80% after \$400,000. India, it seems, has no children's allowance and Canadians will not be much impressed by the claim that the "high exemption limit" of about \$800, plus a further \$400 for married persons, offsets this disadvantage.

The Indian government authorities are to be congratulated on this publication. A similar government attempt to clarify the complexities of

our Income Tax Act would surely find a ready market in this country.

KENNETH F. BYRD, C.A.,
McGill University

Addresses of Publishers

[The] *Controller*, 2 Park Ave., New York 16, N.Y.

Cost and Management, 66 King St. E., Hamilton, Ont.

Fortune, 9 Rockefeller Plaza, New York 20, N.Y.

Journal of Accountancy, 270 Madison Ave., New York 16, N.Y.

N.A.C.A. Bulletin, 505 Park Ave., New York 22, N.Y.

AN UNPOPULAR PURSUIT

I have been in politics all my life. I have spent 45 of my adult years watching Parliament and public life from a ringside seat. As I go about this country and speak to my fellow citizens about the thing which interests me, what is it they tell me? In 75 cases out of 100 they tell me "I am not interested in politics".

Politics — that is our way of life. That is its foundation, its base. That is the thing which makes democracy today the system which you talk about. That is the shield, the safeguard, the lifeblood of the system which we say we believe in, which we want to defend. But we are not interested in politics!

Politics — what is politics? It isn't ward patronage. I know the conception that operates in the average mind, that politics is something low, something degrading, something disreputable. But politics — and people tend to forget this — makes and administers our laws. Politics establishes our rights and duties. Politics disposes of our property and may in certain instances dispose of our lives. Politics can help or hinder prosperity. Politics may undermine or protect religion. Politics may make war or pursue peace.

From an address by Grattan O'Leary, associate editor of *The Ottawa Journal*, to the Dominion Mortgage and Investments Association published in the *Canadian Tax Journal*, July-August 1956.

Students Department

Associate Professor,
Queen's University

CRITICISMS OF THIS DEPARTMENT

We are not as thin-skinned as we once were and, we hope, are now less likely to bridle at criticism; we are genuinely concerned to make this section of benefit to its readers, and appreciate constructive comments and criticisms from whatever source.

During the past year we undertook to write personally to three or four students from each of the provincial Institutes in Canada, asking for suggestions for the improvement of this section, and we received some very helpful replies. The most common suggestions, which we would like to discuss briefly, were:

1. The publication of more auditing problems and solutions.
2. Supplementary discussion of the problems and solutions published.
3. Publication of primary examination problems and solutions.
4. Introduction of a forum for the discussion of student difficulties.
5. Discussion of examination techniques.

Several of these suggestions raise a question about the amount of space which should be available to the Students Department. The Editorial Committee has allotted, on the average, ten pages each month to this section; and we suggest, in view of the variety of interests which the magazine must serve, that this is a reasonable allocation.

* * *

We are pleased to report that dur-

ing the past year there has been a definite increase in the number of auditing problems and solutions published; and that one or two intermediate auditing problems and solutions have appeared in addition to those of the final examination. The price of publishing more auditing problems has, however, been that because of the space available, we have had to abandon the publication of the complete accounting problems and solutions, although the majority of such problems and solutions will still appear. The editor has, therefore, the task of deciding which accounting and auditing problems are likely to be of most interest and value to students. There is a limit to the usefulness of publishing problems and solutions of the auditing examination at the expense of those of the accounting examination, especially because the solutions to some of the auditing problems are readily available in one of the standard texts — as, for example, "List the audit procedures required in the verification of the inventory figure."

* * *

We believe that since the alternative to the publication of supplementary discussion of the problems and solutions may often be the publication of an *additional* problem and solution, such discussion should be kept to a minimum and confined to instances in which there is something especially useful to say about the problem or its solution. About

three years ago we asked the Board of Examiners of the Canadian Institute whether it would be possible to publish examiners' comments, and regard its permission to do so as a generous and helpful contribution. In addition to the examiners' comments, we sometimes publish "editor's notes" along with the solutions especially where, from our working of the problem, certain alternatives have occurred to us as acceptable solutions.

* * *

One difficulty with the publication of primary examination problems and solutions is that the primary examination is not uniform across the country (as are the intermediate and final examinations). A number of the provincial Institutes have, however, adopted the Ontario Institute primary examination and we have, accordingly, published a limited number of primary problems and solutions from this examination during the past year and hope to continue to do so.

* * *

The fourth suggestion has been implemented in the form of a "Question Corner", and student readers are invited to address questions to the editor which are of general student interest. The limitation in the value of this feature must, of course, be the worth of the editor's opinions in attempting to answer the questions submitted, but we trust that those who disagree violently will write to say so, and so eventually bring us to the best solution. To encourage student contributions, small awards of \$5.00 are now paid to readers who contribute material which the editor considers suitable for publication.

* * *

The final suggestion is the one with

which we have the most difficulty. Perhaps we should simply admit that we do not know of any easy way of passing examinations. As the occasion has permitted, we have published everything useful that has come to hand on this topic; but we protest that the number of things which one can say on examination techniques is decidedly limited, and to keep repeating them each month in the Students Department would not serve any purpose.

Perhaps the most helpful thing we could say on this topic would be, on the surface, a cruel thing: namely, that we know of no magic formulae for passing examinations, and that the things which count for more than anything else in writing examinations are *knowledge* and *ability*. We suspect that some candidates who have not done well on their examinations have refused to admit this point to themselves and have, to use the psychologist's term, "rationalized" their shortcomings by insisting that those who have done better have merely a better examination technique. We have been marking university accounting examinations for a number of years and have yet to find an instance in which the difference between a pass and a failure could be clearly identified as merely poor examination technique; at least the poor examination technique we have seen seems to have been peculiarly associated with a lack of knowledge and ability, perhaps even a result of it.

Since we have not, by any means, secured 100 per cent on the examinations we have attempted ourselves, we offer these comments humbly. Such "examination techniques" as we know about are few in number, and can be described briefly. They are:

1. In preparing for an examination, try former papers under self-imposed examination conditions, and the more, the better. (This is hardly a "magic formula" for passing, however, since it involves a great deal of hard work.)
2. Take time at the beginning of the examination to read the whole paper over and decide, in the light of one's knowledge, which questions to attempt first. But having done this, proceed with the question, start writing, put something down on paper, even though the final answer is not immediately apparent; it may well become apparent as one proceeds. There is nothing worse than staring blankly at a question merely because one cannot see his way through to the completion of it.
3. Bear in mind the purpose of the examination: it is not to embarrass the candidate into making mistakes, but rather to determine whether he has a sufficient knowledge and ability to take his place beside other qualified members of the profession. Perfect marks are not required for this purpose, and one should therefore concentrate upon securing the most marks possible within the time available.

We are sure that all readers who are concerned about writing examinations (and what student is not!) will want to read the brochure "Chartered Accountant Examinations in Canada—a Guide for Students" recently prepared by the Committee on Education and Examinations of the Canadian Institute.

THE QUESTION CORNER*

The A Bakery Company Limited has carried on business for a number of years and the drivers have been paid commissions not on sales, but, as an incentive for collection of accounts receivable, on cash received. Thus at the end of every week, the driver is paid 30 per cent of the cash he has collected or taken in.

On February 29, 1956, the company was sold and the person buying the company thinks that a provision should be set up on the financial statements as of that date for the 30% commissions that will be paid the driv-

ers on the accounts receivable collected after February 29, 1956. No provision of this kind has previously been set up.

Some of us feel that a provision should be established in such a case and thereafter maintained so that the net income will reflect changes in sales and not in cash received; others feel that the accounts receivable are correctly shown without any provision of this kind and that the subsequent collection is a cost of the new owner. Who is right?

Submitted by J.S., a student-in-accounts, Niagara Falls, Ontario.

* An award of \$5.00 is paid to students-in-accounts who submit questions used in this section, or who make any other contributions which the editor considers to be suitable for publication in the Students Department.

Editor's Reply

The following journal entry would, we presume, give effect to the accounting treatment by which the estimated costs of collection are deducted from accounts receivable and added to the expenses of the period in which the sales are made:

Collection commissions expense	300	
Allowance for costs of collection		300
To record estimated commissions payable on sales made by drivers to end of accounting period.		

On the balance sheet the allowance would then be shown as a deduction from the accounts receivable:

Accounts receivable	\$1,200
Less allowance for doubtful accounts	200

	1,000
Less allowance for costs of collection	300

	\$700

It can be argued in favour of this treatment that a more precise figure of working capital is produced and that, in computing income, costs are matched more closely with sales.

In "An Introduction to Corporate Accounting Standards" pages 55-56, Paton and Littleton discuss the accounting problem arising in a situation of this kind, and stress the importance of matching costs with revenues. They conclude therefore that future collection costs may properly be deducted from accounts receivable and added to the expenses of the period in which sales are made. Their reasoning is as follows:

Adjustments to recognize the effect of costs applicable to current sales which are expected to be incurred in the period following sale ("after costs") present a

more difficult problem of interpretation. The usual procedure, when an effort is made to anticipate the effect of such a cost, is to charge expenses and credit some form of allowance . . . account with the estimated amount. Thus collection expense is sometimes charged with the estimated cost of billing and collecting the outstanding receivables originating in the current period, and [allowance or provision] for collection expense is credited. Such an adjustment seems an entirely reasonable step in the effort to perfect the assignment of charges and credits to particular periods; it is not altogether easy, however, to find definitions for the entries which fit into the basic pattern. In general costs should be recognized only when actually incurred; it can hardly be said that the services of billing, etc. to be rendered next month have actually been incurred in the current month. The difficulty is resolved when it is perceived that adjustments for after-costs are a part of the process of measuring the revenues applicable to a particular period *on a sales basis*. The charge for the estimated amount of such costs then becomes a direct deduction from a revenue that would otherwise be overstated, in its current effect, and the corresponding credit becomes an offset to outstanding receivables as a part of the process of reducing the gross amount to net amount to be realized.

A variation on this accounting treatment suggests itself particularly if the percentage of the cash collected by the drivers is substantially the wage received by them for their week's work—a commission as high as 30% of the money collected from customers may well form the largest part of the drivers' remuneration. If so, there is a case for treating the accrued portion of the commission in the same way as other commissions and salaries. The credit by this reasoning, however, would be in the

nature of an accrued liability rather than a deduction from accounts receivable.

The opposite treatment of recording the collection cost entirely as a cost of the period in which the collections are made, and of creating no allowance or provision, is presumably based upon the argument that it is the act of collecting and not the act of selling which is the basic consideration for the commission payment. A clue as to management's views on

this point may be had by asking what arrangements are made when one driver replaces another: which one receives the commission on the previous week's sales? The counter-argument is that the company's rule about which driver would receive payment, and the time of payment, is a matter of administrative convenience; and that, especially if bad debts are negligible, a commission has in fact been earned by someone as soon as a sale is made.

(Comments on this problem and criticisms of the editor's reply are invited)

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1955

Accounting I, Question 6 (15 marks)

On 15th October 1954, the bondholders and preferred and common shareholders of the R Co. Ltd. approved the following plan of re-organization and refinancing:

- (i) Supplementary Letters Patent are to be obtained cancelling the present authorized capital and substituting an authorized capital of 10,000 5% preferred shares of a par value of \$100 each and 50,000 common shares of no par value.
- (ii) The holders of 6% first mortgage bonds are to receive \$300 in new 4% bonds at par and one 5% cumulative preferred share for each \$400 bond presently held.
- (iii) The preferred shareholders are to receive the following:
 - (1) Two 5% preferred shares and one new common share for every four 8% preferred shares presently held.
 - (2) One new common share for every \$64 of accumulated arrears of preferred dividends.
- (iv) The common shareholders are to receive two new no par value common shares for every common share of \$100 presently held.
- (v) Investment Dealers Ltd. will purchase 20,000 common shares of no par value at \$25 per share, paying cash in full on application.
- (vi) All common shares are to have an issue price of \$25 of which \$5 is to be credited to distributable surplus.

(vii) The reduction of capital is to be applied in the following manner:

- (1) Goodwill is to be eliminated.
- (2) Patents and franchises to be written down by \$500,000.
- (3) Any balance remaining to be used to write down fixed assets.

The following figures were taken from the balance sheet as at 31 Dec. 1954:

(i) *Authorized issued and fully paid:*

10,000 — 8% cumulative preferred shares of a par value	
of \$100 each (Note 1)	\$1,000,000
7,500 — common shares of a par value	
of \$100 each	750,000
	<hr/>
	\$1,750,000
	<hr/>

NOTE 1: (Preferred dividends have been in arrears since
31st December 1950)

(ii) 6% First mortgage bonds	\$2,000,000
(iii) Goodwill	\$ 100,000
(iv) Patents and franchises	\$1,500,000

Required:

Journal entries, complete with narratives, to record the reorganization, assuming that the Supplementary Letters Patent were obtained and reorganization was effected on 1st Jan. 1955.

A SOLUTION

BOOKS OF R CO. LTD.

1955-

Jan. 1	6% first mortgage bonds	\$2,000,000	
	4% bonds		\$1,500,000
	5% cumulative preferred shares		500,000
	Issue of three 4% bonds and one 5% cumulative preferred share for every four 6% first mortgage bonds outstanding as per plan of reorganization dated 15th October 1954		

Jan. 1	8% cumulative preferred shares	1,000,000	
	Reorganization account		312,500
	5% cumulative preferred shares		500,000
	Distributable surplus		37,500
	Common shares (new)		150,000
	Issue of two 5% preferred shares and one common share at \$25 for every four 8% preferred shares outstanding plus one common share at \$25 for every \$64 accumulated arrears in preferred dividends. 20% of proceeds of issue of common shares credited to distributable surplus per directors' minutes of 31st December 1954		

Jan. 1	Common shares	750,000	
	Common shares (new)		300,000
	Distributable surplus		75,000
	Reorganization account		375,000
	To record issue of two new common shares at \$25 for each old common share. 20% of proceeds of new common shares credited to distributable sur- plus		
Jan. 1	Reorganization account	687,500	
	Goodwill		100,000
	Patents and franchises		500,000
	Fixed assets		87,500
	To apply reduction in capital as agreed		
Jan. 2	Cash	500,000	
	Common shares (new)		400,000
	Distributable surplus		100,000
	To record sale of 20,000 common shares (new) at \$25 to Investment Dealers Ltd. for cash		

Examiner's Comments

The examiner reports that the most common misinterpretations of the question by candidates were: (1) the assumption that dividends in arrears had been declared and set up as a liability at 31 Dec. 1954 and (2) the assumption that R Co. Ltd. had earned surplus at 31 Dec. 1954, and charging the payment of dividends in arrears to this balance.

An acceptable alternative was to use separate journal entries to record the issue of shares to preferred holders for their present shares and the issue of shares to preferred holders for dividends in arrears. Dividend arrears of four and five years were accepted. The examiner expresses a preference for the use of a "Reorganization account" in a problem of this type, but states that he did not consider its use essential.

PROBLEM 2

Final Examination, October 1955

Auditing I, Question 7 (12 marks)

The newly appointed directors of a limited company consider that some of its assets are so grossly overstated that the company has lost part of its capital. They propose to reduce the ordinary shares from \$10 each to \$2.50 each and to change the 6% cumulative non-participating preference shares from \$10 each to \$7.50 each.

The preference shares carry no priority as to capital in the event of winding up, the amounts paid or credited as paid up on all shares of either class ranking equally.

The directors' proposals are criticized:

- (i) By an ordinary shareholder, on the grounds that they will not improve the company's finances and that it is immaterial whether

a distribution of profits is described as 10% on \$2.50 shares or $2\frac{1}{2}\%$ on \$10 shares

- (ii) By a preference shareholder, who contends that the ordinary shareholders will lose nothing since in any event they receive the profits distributed after the preference dividend has been paid.

Required: Comment on these criticisms.

A SOLUTION

Comments on Criticisms of Plan to Reduce Share Capital

Criticism (i)

The common shareholder is correct in his contention that the plan will not improve the company's finances because it does not include the introduction of new capital. On the other hand, the effect of the reduction in share capital will be to present a more realistic figure for the assets and, in turn, to provide a better basis for deciding whether the company's profits represent a reasonable return on the working assets.

If long term assets are written down, depreciation charges will be reduced, and the profit figure increased. While this accounting treatment will not provide additional funds, the company's competitive position may be improved if management decides that prices can be lowered because of the lower recorded costs.

The plan may facilitate the issue of additional capital stock in the future. A dividend rate such as 10% may appear attractive to prospective investors. Moreover, a lower price per share will tap a wider section of the capital market.

Criticism (ii)

The contention of the preferred shareholder is correct in that preferred shareholders will be entitled only to 75% of the amount formerly required for their dividends, and consequently a larger proportion of the profits will be available for the payment of common dividends.

On the other hand, the common shareholders will make a greater sacrifice in the event of the company's winding up. The preferred shareholders' equity will be reduced by only 25% while the common shareholders' equity will be reduced by 75%.

PROBLEM 3

Final Examination, October 1955

Accounting II, Question 1 (10 marks)

On 1st Jan. 1944, N Co. Ltd. having an issued capital of \$5,000,000 in common stock, sold \$3,000,000 5% bonds at a premium of 5%. These bonds mature 1st Jan. 1964 but are redeemable at any prior date at a premium of 3%. The premium on issue is being amortized by equal annual instalments against profit and loss account over the life of the bonds.

On 1st Jan. 1954, the directors are considering the desirability of immediately redeeming the bonds and refinancing on one of the following methods:

- (i) It is possible at this date to issue \$3,000,000 4% bonds or such larger quantity as the directors may wish, at par, with the right of redemption at par at any time after ten years. The expenses in connection with the issue of the 4% bonds would be \$100,000.
- (ii) The company could successfully issue at par \$3,000,000 4% redeemable preferred stock with the option to redeem at any time at a premium of 1%. The expenses in connection with the issue of preferred stock would also be \$100,000.

Required:

- (7 marks) (a) On the basis of the given information, calculate the increase or decrease in the common shareholders' equity over a ten-year period resulting from the alternative refunding schemes as compared with the 5% bonds presently outstanding.
- (3 marks) (b) What do you consider to be the proper treatment of the unamortized premium on the 5% bonds if they are immediately redeemed and the 4% bonds issued? Give reasons for your selection. Indicate any alternative methods of treatment.

A SOLUTION**N CO. LTD.****EFFECT OF ALTERNATIVE FINANCING PLANS ON COMMON SHAREHOLDERS' EQUITY OVER TEN YEARS****Expense for ten years on 5% bonds**

Interest on \$3,000,000 @ 5% p.a.	\$1,500,000
Less amortization of bond premium	
$\frac{150,000}{20} \times 10$	75,000
	<u>1,425,000</u>
Deduct effect of deduction for bond interest on income tax — 49% of \$1,500,000	735,000
Net expense	<u>\$ 690,000</u>

Effect of issue of 4% bonds

Premium on redemption of 5% bonds—	
3% of \$3,000,000	90,000
Expenses of issuing 4% bonds	<u>100,000</u>
	190,000
Less credit to retained earnings for unamortized premium on 5% bonds at time of redemption	<u>75,000</u>
	115,000
Interest expense for ten years—	
\$3,000,000 @ 4% p.a.	\$1,200,000
Less effect of deduction for bond interest on income tax—49% of \$1,200,000	<u>588,000</u>
	612,000
Net expense	<u>\$ 727,000</u>
Decrease in common shareholders' equity	<u>\$ 37,000</u>

Effect of issue of preferred stock

Premium on redemption of 5% bonds	90,000	
Expenses of issuing preferred shares	100,000	
	<hr/>	
	190,000	
Less credit for unamortized premium on 5% bonds	75,000	
	<hr/>	
	115,000	
Dividends on preferred stock for ten years—		
\$3,000,000 @ 4% p.a.	1,350,000	
	<hr/>	
	\$1,465,000	
	<hr/>	
Decrease in common shareholders' equity		\$ 775,000
		<hr/>

(b)

TREATMENT OF UNAMORTIZED PREMIUM ON 5% BONDS IF REDEEMED AND
4% BONDS ISSUED

The preferred treatment is to credit the unamortized premium to retained earnings. The premium on the bonds is in effect an adjustment of the interest charge, and on redemption of the bonds the adjustment is applicable to the interest charges for prior years.

Another logical procedure is to continue to amortize the premium over the remainder of the 20 year original life of the 5% bonds. The argument in favour of this treatment is that the unamortized premium on the old bonds would be one of the factors which would be taken into account in reaching a decision to issue the new bonds.

A third method would be to amortize the premium over the life of the new 4% bonds. As the life of the new bonds bears no relationship to the bonds redeemed, this is not considered an acceptable procedure.

Examiner's Comments

The examiner reports that the most common errors were (i) ignoring the effect of corporation income taxes and (ii) confusing "premium" and "discount".

NEWS OF OUR MEMBERS

British Columbia

J. W. Hudson, C.A. has been named executive vice-president of Burrard Dry Dock Co. Ltd., Vancouver.

Standeven & Davy, Chartered Accountants, announce the retirement from partnership of R. R. Davy, C.A. James M. Standeven, C.A. will continue practice of the profession under his own name.

Helliwell, MacLachlan & Co., Chartered Accountants, announce the admission to partnership in their Vernon office of R. A. Stubbs, B.Com., C.A.

McIntosh, McVicar & Dinsley, Chartered Accountants, 514 Standard Bldg., Vancouver, announce the admission to partnership of Geoffrey Hart, C.A. Practice of the profession will continue under the firm name of McIntosh, McVicar & Dinsley.

Manitoba

Price Waterhouse & Co., Chartered Accountants, and Thornton, Milne & Campbell, Chartered Accountants, 202 The Toronto-Dominion Bank Bldg., Winnipeg, announce the retirement from the firms of Stuart Thornton C.A. and the admission to partnership of the firm of Price Waterhouse & Co. of Donald J. Campbell, C.A.

G. A. Anderson, C.A. has been appointed general manager of Reliance Securities Corporation Ltd., a subsidiary of Western Canada Breweries Ltd.

J. H. Beatty, C.A. has been named comptroller for Western Canada Breweries Ltd. in Manitoba and for Reliance Securities Corporation Ltd.

Canadian Car and Foundry Co. Ltd., Montreal, announces the appointment of J. E. Clubb, C.A. as vice-president (finance) of the company.

Laird, Sprague & Co., Chartered Accountants, and McDonald, Currie & Co., Chartered Accountants, Cooper Brothers & Co., Chartered Accountants, announce the amalgamation of their practices. Hereafter the combined practices will be carried on under the firm names of McDonald, Currie & Co., Cooper Brothers & Co., with offices at 704 Trust & Loan Bldg., Winnipeg. Resident partners will be Daniel Sprague, C.A., C. H. Flintoft, C.A. and W. S. Rennie, C.A.

New Brunswick

A. F. Gosling, C.A. announces the removal of his office to Eastern Trust Bldg., 794 Main St., Moncton.

Newfoundland

Lee & Martin, Chartered Accountants, announce the appointment of J. Douglas Fraser as resident partner of their St. John's office.

Nova Scotia

Nightingale, Hayman & Co., Chartered Accountants, announce that M. L. Pitman, C.A. has been appointed resident partner in the firm's Bridgewater office.

Butterfield & Steinhoff, Chartered Accountants, Hamilton, Bermuda announce the admission to partnership of Karl Wildi, C.A. The firm will continue to practice under the firm name of Butterfield & Steinhoff.

Ontario

R. Wilson Linton, C.A. announces the opening of an office for the practice of his profession at Rm. 202, 88 Richmond St. W., Toronto, Ont.

Phillip Schure, B.A., M.Com., C.A. announces the opening of an office for the

practice of his profession at Temple Bldg., 62 Richmond St. W., Toronto.

Kemp & Birnie, Chartered Accountants, Barclays Bank Chambers, Bay St., Nassau, Bahamas announce the admission to partnership of Donald E. Britchford, C.A., A.S.A.A.

F. R. Palin, C.A. has been elected president of the Canadian Gas Association at its annual meeting held at Murray Bay, Que.

Quebec

The estate of the late Arthur Devonport Hooper, C.A. announces the continuation of his practice by Hugh B. Savage, C.A. and George C. Kendall, C.A. of Savage & Co., Chartered Accountants, 610 St. James St. W., Montreal.

P. J. Taylor, C.A. has been appointed comptroller of Canadian Car and Foundry Co. Ltd., Montreal.

Saskatchewan

G. W. Myers, C.A. has been appointed Director of Finance, Purchasing and Stores, of the Department of Veterans Affairs, Ottawa.

Deloitte, Plender, Haskins & Sells, Chartered Accountants, announce that Harold S. Moffet, F.C.A., partner of their Regina office, has been appointed partner in charge of the firm's Montreal office.

R. C. Kjeldson, C.A. has taken a position with Imperial Oil Company in the exploration accounting department, Calgary.

INSTITUTE NOTES

ONTARIO

Administrative Development — The Institute of Business Administration of the University of Toronto is offering a number of evening courses as part of an "Administrative Development Program" designed to prepare the participants for higher management responsibilities. The program involves serious study of all aspects of organization and management over a period of several years. There are no fixed prerequisites for registration, nor does the program lead to a degree. A descriptive booklet is available on request from the Institute of Business Administration, 273 Bloor St. W., Toronto.

The Institute also has an evening program for university graduates wishing to obtain a Master of Commerce degree.

Educational Requirements — At the annual meeting in June a change was approved in the minimum educational requirements which makes it possible for students to register with eight Grade XIII papers instead of the minimum nine papers previously required. The requirement in mathematics has also been amended and

applicants need offer only one mathematics paper, algebra, provided a standing of at least 60% has been attained. Failing this standing, the applicant will be required to have all three mathematics papers with an average of at least 60% across the three. Full details are contained in the information booklet recently sent to members.

Honours Graduates — The annual meeting also approved a provision whereby honours course graduates of approved universities will be able to accelerate their studies so as to complete them in three years instead of four years as formerly. The information booklet contains details of this change too.

Submission of Lesson Exercises — The Board of Instruction has decided to withdraw the privilege of allowing students to submit two lesson exercises in each of four weeks during the course year. Effective with the instruction year 1956-57 (which starts in the fall of 1956) one lesson exercise only per week will be accepted from any student. The Board hopes by this means to stimulate the regular submission of exercises.

SWEETNESS AND LIGHT

Soon the most recent fad in bank design, a "showcase" bank, will open in a shopping centre on the outskirts of Toronto. All glass on three sides, its only opaque wall is the one containing the vault. To the passerby it will give an impression of spaciousness and easy cordiality which entices him to enter even if only to browse around.

A remarkable change has come over banks in the past 40 years. By tradition they were supposed to be forbidding, austere places. Stephen Leacock used to say that whenever he went into a bank he got rattled. The clerks rattled him; the wickets rattled him; the sight of money rattled him; everything rattled him. Sombre oak stools and counters stood on a floor covered with inevitable brown linoleum, and overhead a high ceiling caught normal human voices in its trap and distorted them into a sepulchral sound. Tightly locked in his cage, the teller peered impersonally through a narrow opening slot at the customer and in case he should ever have trouble he kept his trusty (yet rusty) pistol in full view. Requests for commercial loans and overdrafts were regarded with caution amounting almost to suspicion, while personal loans were practically non-existent. The banker himself, as a representative of the white-collar class, made sure that his collars were starched stiff and often he cultivated a manner to match his neckwear.

Today, especially in the newer districts, a trip to the bank can be a real

treat, no matter what the purpose. Glass doors swing open easily and the customer's eye meets a combination of blonde woodwork and ribbed glass. Walls are pastel and the low ceiling is covered with acoustic tile. In the teller's section (few are still confined by cages) stand a bevy of comely young ladies armed only with a pleasant smile ready to take a deposit or cash a cheque. One bank even advertises the good looks of its employees as a feature of its service, though no doubt it makes sure they can add and count too. Needless to say the better looking the girl, the longer the line-up in front of her wicketless wicket.

But at the front of the bank there is another line-up equally as long. These are the people who have come to see about borrowing money for the purchase of a TV set or some household appliance, and somehow the manager and accountant have learned in the last few years to keep smiling when they hear that word "loan" on the lips of a customer. No longer do they automatically switch to the fishy stare which was once their standard refuge, for they realize that lending money means they are doing business and that is what they are there for.

The modern bank has extended its services too. A customer can make deposits at night by dropping a bag into a chute. In some places he can transact his business without even leaving his car. But one Canadian bank has the best idea yet. Noting that many of its customers are young married women, it offers a baby-parking service, the chief baby-sitter being no less a personage than the branch manager.

With all this and an interest rate of 2½%, the day of the old sock or slit in the mattress is surely done.

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PRACTICE WANTED: Firm of chartered accountants desires to purchase practice in Toronto or Southern Ontario. Box 591.

CHARTERED ACCOUNTANT wanted for practice in Saskatchewan with a view to partnership

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Senior who is writing final this year. Partnership prospects on qualification. Replies to Box 587.

CHARTERED ACCOUNTANT, age 31, seven years' experience in public accounting and four years in industry, at present holding position of assistant treasurer, desires to become associated with firm of practising accountants in Toronto area with a view to eventual partnership. Box 595.

INTERMEDIATE AND PRIMARY STUDENTS required by Sharp, Milne & Co., Rm. 902, 80 Richmond St. W., Toronto. Empire 6-1196.

STUDENTS WANTED: Well-known Nova Scotia firm of chartered accountants has openings for third and fourth year students. Applications will be held in strict confidence. Send full particulars as to age, educational, marital status, etc. to Box 594.

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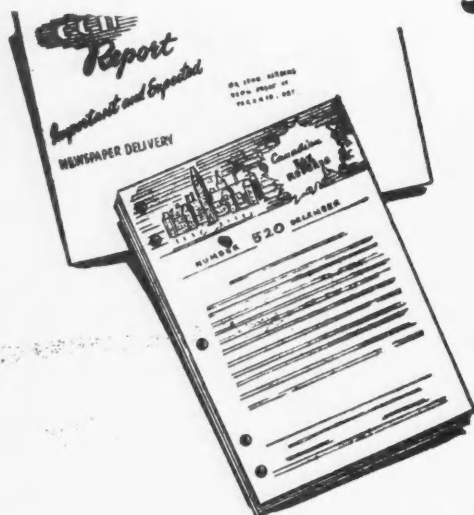
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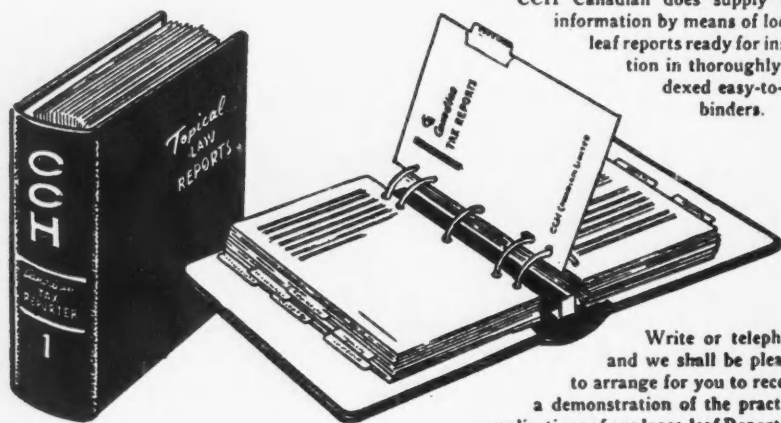
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